ANNUAL REPORT

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Federal Student Aid
2006

U.S. Department of Education | Federal Student Aid

Dear Federal Student Aid Colleagues, Partners and Customers,

I am pleased to present Federal Student Aid's FY 2006 *Annual Report*. Last year marked a period of many successes for Federal Student Aid. We disbursed more than $77 billion in aid to over ten million students and their families while reducing the operating cost to disburse these funds. This represents the largest annual disbursement of federal student aid to more students at lower operating cost than any other time in history. It is noteworthy that nearly 95 percent of Federal Student Aid's approximately 14 million applicants now use *FAFSA on the Web* to apply for federal student aid, an incredible adoption rate for what was an entirely paper-based process only a decade ago. This conversion from paper to electronic applications saves millions of dollars annually in processing, printing and postage costs.

While disbursing this record-breaking amount of federal student aid to students and families, Federal Student Aid faced several challenges in FY 2006. During the year, we continued to provide much needed support to schools, students and families affected by the hurricanes that struck the Gulf Coast region in August and September 2005. Additionally, we provided monitoring and oversight of closed schools and impacted schools, lenders, and guaranty agencies to ensure proper administration and payment of Title IV funds in accordance with all issued emergency guidance. We also implemented strict financial controls around relief aid provided to schools in accordance with all Office of Management and Budget (OMB) guidance.

Pandemic flu preparation and readiness was identified as a national initiative and Departmental priority, and Federal Student Aid needed to develop plans to ensure the continuity of our business operations and delivery of federal student aid to be fully prepared should a pandemic flu outbreak occur. We also are in the process of developing guidance for schools and other Title IV program participants to assist them in the event that a pandemic flu outbreak impacts their ability to administer the Title IV programs.

Finally, passage of the Higher Education Reconciliation Act (HERA) in February required that Federal Student Aid implement over 65 new or changed statutory provisions. This implementation required almost every Federal Student Aid business function and supporting system be modified to support the provisions by July 1, 2006, less than five months after enactment of the HERA. The most significant of these was the design, development and implementation of two new grant programs, the Academic Competitiveness and National Science and Mathematics Access to Retain Talent (SMART) Grant programs, as well as a new loan program for graduate students, the Student PLUS loan program. All three of these new programs, including the development and delivery of training sessions to over 10,000 financial aid administrators and other program participants, were implemented by July 1, 2006.

Notwithstanding the challenges and opportunities discussed above, we maintained our focus on our long-term strategies to identify new and innovative ways to improve the accuracy and efficiency of aid delivery through new technology solutions. We launched the Integrated Partner Management solution, which will provide an end-to-end view of Federal Student Aid's approximately 10,000 operating partners, improving the management of partner interactions and supporting the delivery of Title IV funds. We improved the performance of and reduced the cost of operating our supporting technical infrastructure by awarding a new contract for the operation of Federal Student Aid's Virtual Data Center. The Virtual Data Center provides a single computing environment for hosting all of Federal Student Aid's information technology resources.

Additionally, one of our core responsibilities is to ensure that student aid under the Title IV programs is delivered directly by Federal Student Aid and through school, lender and guarantor participants in a manner that reduces the vulnerability of these programs to fraud, waste, abuse and mismanagement. Included in our many initiatives was the development and implementation of standardized processes across Federal Student Aid's 10 regional offices for reviewing the over 6,000 schools that participate in the Title IV programs for compliance with program requirements. We also improved the methods for monitoring guaranty agencies' compliance with required reserve ratios. As a result, this year, several agencies have been asked to submit management plans for improving their reserve ratios. We also successfully implemented and completed the full testing of Federal Student Aid's financial reporting internal controls under the new OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A revisions.

Finally, in FY 2006, Federal Student Aid began the full-scale implementation of our multi-year enterprise communications strategy that was launched in FY 2005. This strategy was developed to better articulate the benefits of postsecondary education, raise awareness of federal student aid programs and improve consistency across all communications to Federal Student Aid's many stakeholders. We began a comprehensive public service campaign utilizing media, print and Web executions to increase Federal Student Aid outreach to targeted, underrepresented populations.

These achievements, and many others, were the result of the hard work and dedication of the nearly 1,100 Federal Student Aid staff that work with diligence, determination and a passion to serve our customers. I am honored to present this report on their behalf.

Theresa S. Shaw
Chief Operating Officer

FY 2006 Annual Report

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Management Discussion and Analysis

Mission and Organizational Structure

Federal Student Aid, a principal office of the U.S. Department of Education (the Department), ensures that all eligible individuals can benefit from federally funded or federally guaranteed financial assistance for education beyond high school. We consistently champion the promise of postsecondary education to all Americans—and its value to our society.

Federal Student Aid plays a central and essential role in supporting postsecondary education. We partner with postsecondary schools, financial institutions and other participants in the Title IV student financial assistance programs (Title IV programs) to deliver programs and services that help students finance their education beyond high school. Today, Federal Student Aid is responsible for a range of critical functions that include, among others:

- Processing millions of student financial aid applications;
- Disbursing billions of dollars in aid funds to students through schools;
- Enforcing financial aid rules and regulations;
- Partnering with schools, financial institutions and guaranty agencies to prevent fraud, waste and abuse;
- Educating students and families on the process of obtaining aid;
- Servicing millions of student loan accounts;
- Securing repayment from borrowers who have defaulted on their loans; and
- Operating information technology systems and tools that manage billions in student aid dollars.

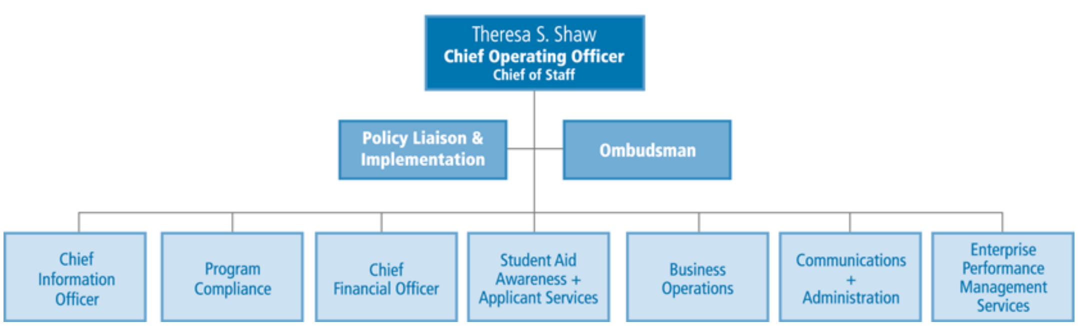
This is a complex, multifaceted mission that calls on a range of staff skills, and demands coordination by all levels of management. Designated a Performance-Based Organization (PBO) by Congress in 1998, Federal Student Aid emphasizes tangible results and efficient performance, as well as the continuous improvement of the processes and systems that support our mission.

Federal Student Aid Organizational Structure

Federal Student Aid currently operates under a functional structure that aligns our organization closely with our strategic drivers, business objectives and mission goals. This structure reinforces a key business goal: efficient, effective and productive interaction with our many stakeholders.

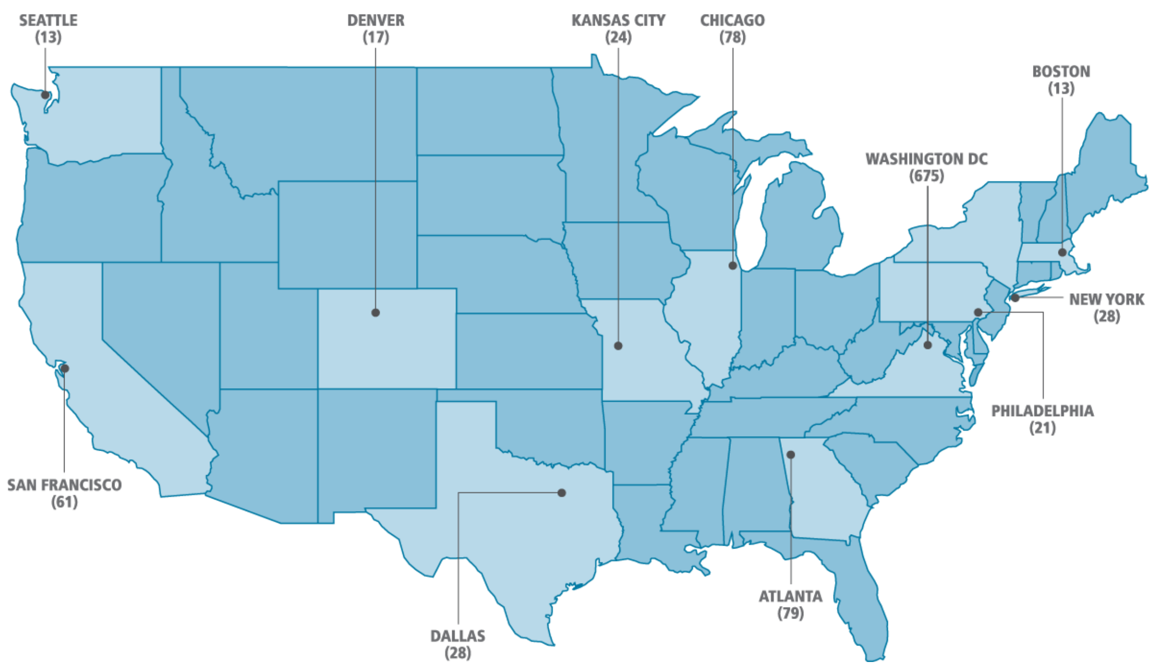
This community of stakeholders includes students and parents, schools, lenders, guaranty agencies and taxpayers, as well as other federal entities and the Department itself. The graphic below illustrates the current functional structure of Federal Student Aid.

Federal Student Aid Organizational Structure



Chief Operating Officer Theresa S. Shaw, who was appointed to a five-year term by the Secretary of Education in 2002, leads Federal Student Aid. In fiscal year (FY) 2006, the organization operated on an annual administrative budget of $658 million. Our staff of nearly 1,100 is augmented by contractors who provide outsourced business operations. This workforce is based out of Washington, D.C., with 10 regional offices located throughout the country.

Federal Student Aid Regional Map



As a federally designated PBO, Federal Student Aid operates under a congressional mandate to achieve concrete mission results as we improve efficiency in operations and manage and mitigate risks in Title IV portfolio performance. Federal Student Aid has focused on innovations for upgrading student aid delivery and servicing operations, vendor and contract management, budgeting and cost control and financial and operational management. Much of the resulting operational performance improvement stems from business process reengineering and large-scale technology integration.

Federal Student Aid is responsible for helping students manage the costs of education beyond high school. This duty includes administering the federal student financial assistance programs authorized under Title IV of the Higher Education Act (HEA) of 1965, as amended. The Title IV programs collectively represent the nation's largest source of financial aid for postsecondary students. In the paragraphs that follow, we briefly describe each of the major Title IV programs that deliver aid to students and their families.

The **Federal Pell Grant (Pell Grant) Program** helps ensure financial access to postsecondary education by providing grant aid to low- and middle-income undergraduate students. The most need-based of the Department's student aid programs, Pell Grant awards vary according to the financial circumstances of students and their families. For the 2005–2006 award year, the Department disbursed $12.7 billion in Pell Grants averaging $2,456 to more than 5.2 million students. The maximum Pell Grant award remained at $4,050 for the 2005–2006 award year.

In February 2006, the president signed into law two new student grant programs—the **Academic Competitiveness Grant (ACG)** and **National Science and Mathematics Access to Retain Talent (SMART) Grant**, which were created by the Higher Education Reconciliation Act of 2005 (HERA). The ACG is for full-time undergraduates, who are U.S. citizens and are eligible for a Pell Grant. The student must have completed a rigorous high school program, as determined by the state or local education agency and as recognized by the Secretary of Education. First-year students may receive an ACG award up to $750, whereas second-year students may receive up to $1,300 if they have maintained a cumulative grade point average (GPA) of at least 3.0. The ACG award is available in the 2006–2007 school year for first-year students who graduated high school after January 1, 2006, and second-year students who graduated high school after January 1, 2005. The ACG award is in addition to the student's Pell Grant award.

The National SMART Grant Program provides up to $4,000 to third- and fourth-year undergraduates studying full-time and majoring in physical, life or computer sciences, mathematics, technology, engineering or in a foreign language critical to national security. The student must be a U.S. citizen and meet eligibility requirements for a Pell Grant. The student must maintain a cumulative GPA of at least a 3.0 for coursework required for the major. The grant award is in addition to the student's Pell Grant award.

A student cannot receive more than one ACG or National SMART Grant award in each academic year for which they are eligible.

The **Federal Supplemental Educational Opportunity Grant (FSEOG)**, the **Federal Work-Study (FWS)** and the **Federal Perkins Loan (Perkins) Programs** are three campus-based programs through which the Department provides funds directly to eligible institutions, enabling them to offer grants, employment and low-interest loans to students based on need. For the 2005–2006 award year, approximately $3.3 billion was disbursed through approximately 2.6 million campus-based awards.

There are two **state grant** programs. The **Leveraging Educational Assistance Partnership (LEAP) Program**, authorized by Section 415A of the HEA of 1965 (as amended), makes federal funds available to assist states in providing student financial assistance programs for individuals with substantial financial need. The **Special Leveraging Educational Assistance Partnership (SLEAP) Program** was added to the LEAP Program in the 1998 Amendments to the HEA (Section 415E). SLEAP makes federal funds available to states to cover a third of the cost of supplementing their respective LEAP programs, supplementing their LEAP Community Service Work-Study programs, and/or providing Merit and Academic Achievement or Critical Careers Scholarships, to students with substantial financial need.

Two major student loan programs account for nearly all of the remainder of the Department's financial assistance for postsecondary education. Loans made to students can either be subsidized or unsubsidized. With subsidized loans, the government pays the interest while the student is in school and during qualified periods of grace and deferment. This is not the case with unsubsidized loans, where the student borrower is responsible for paying the interest on the loan. Loans to parents of students are also available.

In FY 2006, Federal Student Aid delivered or supported the delivery of approximately $77 billion in federal aid to over 10 million postsecondary students and their families. These students attend more than 6,100 institutions of postsecondary education accredited by dozens of agencies. Many of these students receive loans from approximately 3,200 lenders with 35 agencies guaranteeing those loans.

In fulfilling our program responsibilities, Federal Student Aid directly manages or oversees more than $448 billion in outstanding loans—representing almost 80 million student loans to over 27 million borrowers.

The **Direct Loan Program** lends funds directly to students and parents through participating schools. This program is funded by borrowings from the U.S. Treasury, as well as an appropriation for subsidy costs. In FY 2006, the Department made $12.4 billion in net loans[1] to 1.8 million recipients.

Under the **Federal Family Education Loan (FFEL)** Program, students and parents can obtain loans through private lenders. Loan guaranty agencies insure these funds, and they are, in turn, reinsured by the federal government. During FY 2006, Federal Student Aid supported the delivery of $46.2 billion in net loans[2] to 6.2 million FFEL recipients. In the same year, Federal Student Aid made gross payments of $8.9 billion to lenders for interest and special allowance subsidies, and $4.6 billion to guaranty agencies for reinsurance claims and fees paid to guaranty agencies for loan processing, issuance and account maintenance.

[1] Excludes consolidation loans of $20 billion.
[2] Excludes consolidation loans of $81 billion.

Performance Goals, Objectives and Results

Since Federal Student Aid became a PBO in 1998, we have introduced many substantial and measurable improvements in how we plan and report our operational and portfolio performance in administering the federal student financial assistance programs.

Strategic Planning and Reporting

Several key strategic drivers form the scope and content of Federal Student Aid's long-term goals and objectives:

- HEA Legislation
- Federal Financial Management Laws and Regulations
- Customer Needs
- PBO Legislation
- The Department's Strategic Plan
- The President's Management Agenda (PMA)
- The Department's Management Challenges

The foundation of our long-term strategic planning is Federal Student Aid's five core strategic objectives. Taken collectively, these objectives provide the framework for continuous improvement at Federal Student Aid, guiding us in managing our programs more effectively and providing clear strategic direction to all of Federal Student Aid's internal and external constituencies.

Our core strategic objectives are:

- To integrate Federal Student Aid systems and provide new technology solutions;
- To improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement;
- To reduce program administration costs;
- To improve human capital management; and
- To improve products and services to provide better customer service.

Federal Student Aid's long-term planning is outlined in its ***Five-Year Plan***, a statement of strategic direction providing long-term guidance. Beginning with the FY 2006 – FY 2010 ***Five-Year Plan***, Federal Student Aid established and documented strategic performance standards to measure the organization's success in meeting the stated long-term objectives. Federal Student Aid will begin reporting our performance as measured by these established standards in this report.

Tactical Planning and Reporting

Federal Student Aid's ***Annual Performance Plan*** establishes specific tactical initiatives to achieve each of the organization's strategic objectives outlined in the ***Five-Year Plan***. Timelines, milestones and status are maintained in the ***Annual Performance Plan*** and evaluated on a monthly basis to ensure their alignment with current business needs, the allocation of resources, the availability and allocation of capital and operating funds, policy considerations, and statutory and regulatory requirements.

The ***Annual Report*** provides the mechanism for reporting the organization's annual tactical performance results, including the organization's audited financial statements and the organization's progress in meeting tactical goals established in the ***Annual Performance Plan***. These three documents—the ***Five-Year Plan***, the ***Annual***

Performance Plan and the ***Annual Report***—form the foundation of Federal Student Aid's strategic planning, tactical implementation and reporting processes.

Additionally, Federal Student Aid continues to improve the systems and procedures used to identify, budget, select, monitor and improve operations. Performance monitoring includes weekly and monthly project planning and reporting activities detailing the scope, schedule, cost, quality and overall status of key initiatives. Federal Student Aid's budget management processes and our unit-cost model provide cost identification, control and management. Federal Student Aid also continually tracks and reports enterprise-wide operational, human capital and performance metrics through a series of dashboard reports.

Key Performance Goals and Results

This section provides a high-level overview of Federal Student Aid's FY 2006 performance objectives and results. The information presented in the following section provides a summary of our achievements and our progress in meeting the organization's stated performance standards. See the Annual Program Performance Report section of this report for additional information regarding our accomplishments and Federal Student Aid's FY 2006 Annual Performance Plan for specific details regarding the organization's progress in meeting each Performance Plan tactical goal.

During FY 2006, Federal Student Aid made significant accomplishments, as well as progress in meeting our performance standards as outlined in the FY 2006 – FY 2010 Five-Year Plan. Under each objective below, we have identified the corresponding Performance Standard as well as the organization's progress in meeting the stated target. Unless otherwise noted, these performance standards and their respective ratings are based on criteria established by Federal Student Aid.

Objective 1: Integrate Federal Student Aid systems and provide new technology solutions.

Federal Student Aid will improve efficiency and productivity, reduce system maintenance and overhead costs and increase the operating ease for users of our systems. Federal Student Aid will continue to provide appropriate and integrated technology solutions that enable ongoing improvements for a more efficient and cost-effective delivery and administration of the federal student financial assistance programs. In addition, the organization will take advantage of new technologies to improve application processing, customer service, productivity and efficiency. In FY 2006, we successfully:

- Awarded a four-year contract for the development of the Integrated Partner Management System (IPM). The IPM project will integrate, modernize and reengineer Federal Student Aid monitoring and oversight functions and provide better customer service to trading partners using a single sign-on process to multiple Federal Student Aid systems.
- Awarded a ten-year contract to operate the Virtual Data Center (VDC). The VDC houses the basic computer systems that support and operate delivery of Title IV student aid.
- Integrated three new systems into the security architecture infrastructure.
- Completed the enterprise portal strategy for the consolidation of many of the existing Web sites.
- Ranked 4th of all government agencies in the Office of Management and Budget's (OMB) Enterprise Architecture assessments.
- Attained a "green" score on the PMA scorecard for e-Gov initiatives and received the Department of Labor's Partner Appreciation Award.

- Continued identifying requirements and completed a technical proof of concept for the ADvance solution, an initiative to modernize and integrate the organization's core front-office business functions through the reengineering, retirement and replacement of existing aid delivery systems.
- Continued design of the Common Services for Borrowers initiative, a solution that consolidated Federal Student Aid's back-office systems for Direct Loan Servicing, Consolidation and Collections into a single integrated solution.
- Completed the conceptual design and high-level functional specifications for the Information Framework solution, an initiative to improve Federal Student Aid's business operations and data management functions by centralizing data transformation services, serving as a centrally accessible record for shared data, and increasing the standardization, quality and traceability of the master data shared among Federal Student Aid systems.

Performance Standards and Results

The following performance standards were established to measure our success in achieving our key integration initiatives. Success is predicated on the timely completion of all scheduled project deliverables in the design, development and implementation phases of the four main systems integration initiatives as described below.

Objective 1: Integrate Federal Student Aid systems and provide new technology solutions.			
Integration Initiative	**FY 2006 Target**	**FY 2006 Actual**	**Performance**
Common Services for Borrowers[1]	Development	Design	Target Not Met
ADvance[2]	Development	Design	Target Not Met
Integrated Partner Management	Design	Design	Target Met
Information Framework	Design	Design	Target Met

[1] The Common Services for Borrowers project did not meet its projected target due to delays in meeting established timelines.
[2] The ADvance project did not meet its projected target due to a change in the acquisition strategy.

Objective 2: Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement.

Federal Student Aid will ensure that student aid under the Title IV programs is delivered directly by Federal Student Aid and through school, lender and guarantor participants in a manner that reduces the vulnerability of these programs to fraud, waste, abuse and mismanagement. Federal Student Aid is continually working to improve program integrity and is committed to continued success in the management of the Title IV programs. In FY 2006, we successfully:

- Achieved a "green" progress score on the September 30, 2006 PMA scorecards for Financial Management and Eliminating Improper Payments and a "yellow" progress score for Credit Management as of September 30, 2006. Achieved status scores of "green" for Financial Management, "yellow" for Eliminating Improper Payments and "red" for Credit Management also as of September 30, 2006.
- Developed and will publish the first iteration of the Cumulative Lifetime Default Rate for the Title IV student loan portfolio.
- Achieved a continued low rate for the National Cohort Default Rate (NCDR) for FY 2004.
- Achieved FY Direct Loan and FFEL default recovery goals for FY 2006.

- Developed and implemented standardized processes across Federal Student Aid's regional offices for reviewing the schools that participate in the Title IV programs. This implementation included the training of many school program review staff.
- Developed and implemented a standard model for evaluating Voluntary Flexible Agreements (VFA) for cost neutrality.
- Achieved an unqualified audit opinion for FY 2006 for the fifth consecutive year.
- Developed and implemented a management tool to evaluate the financial condition, including reserve ratios and fund balances, of guaranty agencies.
- Developed a strategy to improve the monitoring of publicly traded schools.
- Successfully implemented OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A and sound financial management controls. In addition to complying with OMB requirements, Federal Student Aid established an internal control framework to be leveraged for continuous internal control improvement.
- Volunteered to complete a physical inventory of assets in response to an unanticipated issue with the Department's Information Technology asset management inventory.
- Successfully upgraded the financial management system (FMS) to Oracle Federal Financials application version 11i and database version 10g.

Performance Standards and Results

The following performance standards were established to gauge our success in improving program integrity, while reducing the vulnerability of the Title IV programs to fraud, waste and abuse. Our success relies on maintaining "green" status on the PMA, continuing to achieve low default rates and increasing the recovery rate.

<table>
<tr><td colspan="5">Objective 2:
Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement.</td></tr>
<tr><th>Metric</th><th>FY 2006 Target</th><th colspan="2">FY 2006 Actual</th><th>Performance</th></tr>
<tr><td>PMA score for financial management*</td><td>Green</td><td colspan="2">Green</td><td>Target Met</td></tr>
<tr><td>PMA score for improper payments*</td><td>Yellow</td><td colspan="2">Yellow</td><td>Target Met</td></tr>
<tr><td rowspan="5">Cumulative Lifetime Default Rate – Title IV Student Loan Portfolio</td><td rowspan="5">Develop Baseline</td><td>FY 1999</td><td>12.24%</td><td rowspan="5">Target Met</td></tr>
<tr><td>FY 2000</td><td>11.82%</td></tr>
<tr><td>FY 2001</td><td>9.93%</td></tr>
<tr><td>FY 2002</td><td>7.82%</td></tr>
<tr><td>FY 2003</td><td>5.48%</td></tr>
<tr><td>Cohort Default Rate</td><td>< 6%</td><td colspan="2">5.1%</td><td>Target Met</td></tr>
<tr><td>Direct Loan Default Recovery Rate</td><td>19.0%</td><td colspan="2">19.0%</td><td>Target Met</td></tr>
<tr><td>FFEL Default Recovery Rate</td><td>19.3%</td><td colspan="2">19.4%</td><td>Target Met</td></tr>
</table>

*See www.results.gov for definitions, trend and PMA scorecard support for both financial management and improper payments.

Objective 3: Reduce program administration costs.

Federal Student Aid will reduce the cost of administering the Title IV programs through strong financial, operational and budget management; the reengineering of overly complex business processes; and simplification of the business application and computing environment to reduce system complexity, minimize integration challenges, align contracts and reduce vendor management. Our aim is to improve the exchange of data with program participants and across the Federal Student Aid enterprise. In recent years, Federal Student Aid has maintained a relatively flat operating budget, while supporting continued increases in program volume and workload. Federal Student Aid's ability to manage and control operating expenses is based on a philosophy of good fiscal management and continuous process improvement practices that increase productivity and operational efficiencies as well as innovation in our products, services and supporting technologies. In FY 2006, we successfully:

- Completed the development of the unit cost baseline through our Activity-Based Costing (ABC) Model.
- Continued to manage and control operating expenses through efficiencies, productivity gains and capital savings.
- Awarded a ten-year contract to operate the VDC.
- Awarded a four-year contract for the development of the IPM.
- Developed and adopted a coordinated technical and business management approach to plan, execute and manage acquisitions, while ensuring the highest value of service is received for the lowest possible cost while allowing program management flexibility across all business functions.
- Increased business-analysis capabilities and better procurement planning supported by thorough market research resulted in several highly leveraged contract competitions that were negotiated in Federal Student Aid's favor.
- Significantly increased small-business participation through better internal controls, communications and management emphasis and support.

Performance Standards and Results

Performance standards were established to measure our ability to control costs in an environment of increasing workloads. Success relies on achieving economies of scale in our application, delivery, servicing and collection activities.

Objective 3: Reduce program administration costs.			
Metric	**FY 2006 Target**	**FY 2006 Actual**	**Performance**
Reduce electronic FAFSA direct unit costs	Develop Baseline	$5.04	Target Met
Reduce origination and disbursement direct unit costs	Develop Baseline	$4.42	Target Met
Reduce Direct Loan Servicing direct unit costs	Develop Baseline	$20.95	Target Met
Reduce Collections direct unit costs	Develop Baseline	$0.14	Target Met

Objective 4: Improve human capital management.

Human capital management is a critical component of Federal Student Aid's current business operations and future initiatives. Federal Student Aid continues to grow as an organization that empowers individuals to perform at a high level of effectiveness and efficiency. Federal Student Aid is utilizing innovative hiring and employee development techniques aimed at attracting and retaining highly qualified individuals to create a more productive, results-oriented workforce. Additionally, the organization is committed to workforce development and training to ensure a skilled and highly qualified professional workforce. In FY 2006, we successfully:

- Developed a baseline of data to measure the use of training resources to develop a highly skilled workforce to ensure competency in mission-critical skills/knowledge. This work first involved reaching agreement on mission-critical skills and developing an approach to collecting the data.
- Sought and was granted (on January 9, 2006) additional delegations of human resources authority from the Secretary, with respect to operations, as we interact and collaborate with the rest of the Department, including the Office of Management (OM).
- Continued our progress in institutionalizing sound performance management using the Department's Five-Tier Performance Management System and holding managers accountable for accurately and fairly rating individual performance. The ongoing goal is to clearly differentiate between the five different levels of performance and the delivery of real results.
- Established a new Federal Student Aid Executive Management coordinating structure and realigned large segments of the organization to accomplish key objectives.

Performance Standards and Results

The performance standard for improving human capital management measures our ability to maintain a skilled and knowledgeable workforce. Specifically, the performance measure will identify our mission-critical competencies, identify where current or potential weaknesses exist and identify training plans for individuals to further develop competency/skills/knowledge.

Objective 4:
Improve human capital management.

Metric	FY 2006 Target	FY 2006 Actual	Performance
Use training resources to develop a highly skilled workforce to ensure competency in mission-critical skills/knowledge	Develop Baseline	**Leadership** Train 100% New Supervisors Train 52% Current Supervisors	Target Met
		Acquisitions Train 100% Contracting Officials	
		Project Management Train 100% Key IT Project Managers	
		Federal Student Aid Business Knowledge Train 90% New Employees Train 10% School Compliance Officials Train 40% General Workforce	

Objective 5: Improve products and services to provide better customer service.

Federal Student Aid will make a continuous effort to improve products and services to students and their families and program participants such as schools, lenders and guaranty agencies. Being aware of the concerns of customers is a critical component of our efforts to improve federal student aid products and services. Federal Student Aid intends to reduce the complexity of our products and services, ensure that compliance is maintained, provide customers with 24/7 access and promote increased self-service opportunities for customers. In addition, Federal Student Aid will continue to develop strategies to provide integrated solutions for customers. In FY 2006, accomplishments included:

- The FY 2006 American Customer Satisfaction Index (ACSI) ratings for Federal Student Aid's highest volume products and services – including Direct Loan Servicing, *FAFSA on the Web*, the Common Origination and Disbursement system (COD) and the Lender Application and Reporting System (LaRS) – score in the "Excellent" and "Good" range. The COD system received an improved ACSI score.
- Continuation of the multi-year enterprise communications strategy that was launched in FY 2005 to better articulate the benefits of postsecondary education, raise awareness of federal student aid programs and improve consistency across all communications to its many stakeholders, including currently underserved communities. In FY 2006, Federal Student Aid began full-scale implementation of this strategy, launching a new Federal Student Aid brand and incorporating it across multiple points of presence.

Performance Standards and Results

The following performance standards were established to measure our success in meeting and exceeding customer service goals. Specifically, success is realized with continuous improvement in our customer satisfaction scores for our four main systems.

Objective 5: Improve products and services to provide better customer service.				
Metric (In percentages)	**FY 2006 ACSI Benchmark[1]**	**Revised FY 2006 Target[2]**	**FY 2006 Actual**	**Performance[3]**
Student aid application	75	83	80	Target Not Met
School origination and disbursement	68	76	77	Target Met
Lender payment processing	68	74	71	Target Not Met
Direct Loan borrower servicing	75	77	79	Target Met

More detailed accomplishments are provided in the Annual Program Performance Report section of this document.

[1] ACSI Benchmarks are the average score for private companies in a comparable industry sector.

[2] Federal Student Aid performance targets, established last year and included in the FY 2006 – 2010 Five-Year Plan to measure customer service, were delineated in percentile rank. This was done to provide a common measure of customer satisfaction, regardless of the method or company used to conduct the customer satisfaction surveys. Unfortunately, because it was discovered that so few companies are included in the ACSI sector benchmark averages, the percentile rank does not accurately reflect true performance. For example, a single-point change in the ACSI score of *FAFSA on the Web* resulted in a 21 percent change in percentile ranking.

To establish a better and more representative performance standard to measure customer satisfaction with Federal Student Aid products and services, we have updated our performance measures and targets based on actual ACSI sector averages. If, in the future, we utilize a different gauge of customer satisfaction, we will update our performance standards accordingly.

[3] In FY 2006, Federal Student Aid exceeded its revised customer satisfaction targets for school origination and disbursement and Direct Loan borrower servicing. However, Federal Student Aid did not meet its revised customer satisfaction targets for online student aid application processing or lender payment processing.

Data Quality of Performance Information

Effective decision making requires complete, accurate and reliable data. Funding decisions are made and management actions are taken based on performance information. Reliable information is a prerequisite for effective management. In addition to performance data received from our operating partners, we deal with financial data. Our data-quality processes for financial data are reflected in our financial statements and accompanying notes. Federal Student Aid develops and uses such data for various purposes. One of the most visible areas in which this occurs is the annual budget-development process. The central focus of our budget process is to align goals, objectives, performance measures and program funding levels to develop a performance budget. One of the five government-wide elements of the PMA is the integration of budget and performance, which focuses on making budget decisions based on results.

Federal Student Aid, facing opportunities provided by the integrated performance-based budget process and activity-based management, recognizes the need to improve the accuracy, reliability and completeness of our data. Although immediate connections between specific performance and funding levels are sometimes challenging to make, Federal Student Aid is improving systems to yield reliable performance data to make informed budget and policy decisions. These systems will enhance our budget process and increase the accuracy and reliability of the information we receive from our operating partners.

Analysis of Federal Student Aid's Financial Statements and Stewardship Information

Federal Student Aid is committed to providing sound management, financial systems and controls to ensure that students receive aid and repay loans according to applicable laws and regulations. Federal Student Aid's financial statements are prepared in conformance with accounting principles generally accepted in the United States. Federal Student Aid financial statements are subject to an annual independent audit to ensure that they are reliable and fairly present our financial position.

In FY 2006, Federal Student Aid achieved a fifth consecutive unqualified audit opinion on our financial statements. The Independent Auditor's Report cited no material weaknesses in internal controls. This sustained achievement was critical to Federal Student Aid's removal in FY 2005 from the Government Accountability Office's (GAO) High-Risk List and was the result of substantial improvements to internal controls, continued improvement in our accounting and financial processes and Federal Student Aid's strategic planning and financial reporting.

For FYs 2006 and 2005, the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position and Statement of Financing were prepared on a consolidated basis, and our Statement of Budgetary Resources was prepared on a combined basis as required by OMB Circular A-136, *Financial Reporting Requirements*. The Report of Independent Auditors (opinion) on these statements and accompanying Reports on Internal Control and Compliance with Laws and Regulations are included in this report.

For the FFEL and Direct Loan programs, appropriations are available to cover the subsidy cost of each program, as well as administrative expenses. Subsidy expenses are the net present value of future cash flows. Appropriation authority is available as needed on a permanent basis to finance operations resulting from loans guaranteed in the years before FY 1992. The Pell Grant program receives appropriations that cover actual grant disbursements.

A comparison between significant line items reported in Federal Student Aid's FYs 2006 and 2005 financial statements is presented in the following table. The percentage change for Net Cost of Operations is primarily the result of an increase in FFEL costs as explained in the Statement of Net Cost section.

Summarized Financial Data			
(Dollars in Millions)			
	Percentage Change	**FY 2006**	**FY 2005**
Total Assets	19%	$174,571	$146,505
Total Liabilities	17%	$166,084	$142,455
Net Position	110%	$8,487	$4,050
Net Cost of Operations	64%	$51,031	$31,162

The Balance Sheet

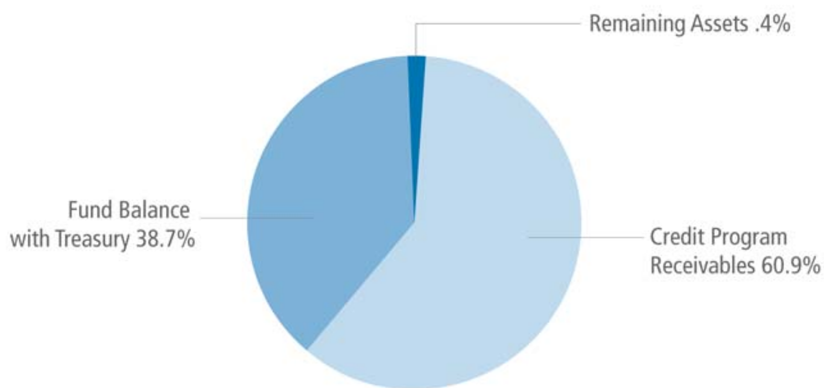
Composition of Federal Student Aid Assets

The Consolidated Balance Sheet shows Federal Student Aid had total assets of nearly $175 billion, as of September 30, 2006. This represents an increase of approximately $28 billion over the previous year's total assets of $147 billion, as of September 30, 2005. The difference is primarily the result of a $29.7 billion increase in Fund Balance with Treasury. The increase in Fund Balance with Treasury results from increases in the balances of about $20.6 billion for FFEL, $3.9 billion in the Direct Loan Program and $5.2 billion for grants. Fund Balance with Treasury was increased primarily as the result of higher subsidy appropriations in the FFEL

Program, reflecting increases in upward subsidy re-estimates and modifications due to increases in loan consolidation volume.

Fund Balance with Treasury represents Federal Student Aid's funds available to make authorized expenditures and finance loan programs. The Treasury processes Federal Student Aid's cash receipts, such as warrants that provide cash for operations and loan payment collections received from students. The Treasury also processes operating expenditures and other disbursements on behalf of Federal Student Aid.

Assets as of September 30, 2006



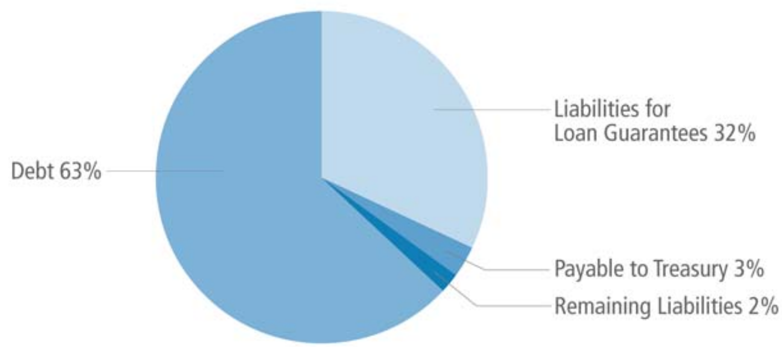
Credit Program Receivables decreased $1.2 billion in FY 2006. Credit Program Receivables are comprised primarily of principal and interest amounts owed by students for Direct Loans and defaulted guaranteed loans under the FFEL Program. As of September 30, 2006, there was $106.4 billon in Credit Program Receivables, the majority of which were Direct Loan program receivables of $92.6 billion and FFEL Program receivables of $13.6 billion. The credit program receivables for FFEL increased from September FY 2005 through September FY 2006 by $1.9 billion. The credit program receivables for Direct Loans decreased by $3.1 billion, primarily due to an increase in the allowance for subsidy. The allowance increased due to accruals for subsidy re-estimates to reflect higher consolidation loan volume and changes to the assumptions for collection rates on consolidation loans.

The remaining assets include Accounts Receivable, Cash and Other Monetary Assets, General Property, Plant, and Equipment and Other Assets.

Composition of Federal Student Aid Liabilities

Federal Student Aid had total liabilities, as of September 30, 2006, of $166.1 billion. Of this amount, $105.4 billion represents the balance due Treasury for previous borrowings used to fund disbursements of Direct Loans to students.

Composition of Liabilities as of September 30, 2006



Debt and Liabilities for Loan Guarantees increased during the period September 30, 2005 through September 30, 2006. Debt for the Direct Loan program expanded due to increases in new borrowings to support the disbursement of new loans over collections from borrowers. Total liabilities increased $23.6 billion primarily due to increases in the Liabilities for Loan Guarantees in FFEL of $21.8 billion and Debt for the Direct Loan program of $1.1 billion. Liabilities for Loan Guarantees for FFEL increased due to upward re-estimates and subsidy transfers from increased loan consolidation activity. The Liabilities for Loan Guarantees under FFEL, which showed increased activity in FY 2006, are the estimated costs on a present-value basis of the net long-term cash outflows, resulting from loan defaults and lender payments that are offset by fees. Loan guarantees encourage private lenders to provide student education loans. The Payable to Treasury balance is the amount owed for downward subsidy re-estimates and for amounts that will be returned to Treasury after all pre-1992 loan guarantees have been satisfied.

The remaining liabilities include Accounts Payable, Guaranty Agency Federal and Restricted Funds Due to Treasury, Other Intra-governmental Liabilities, Accrued Grant Liability and Other Liabilities.

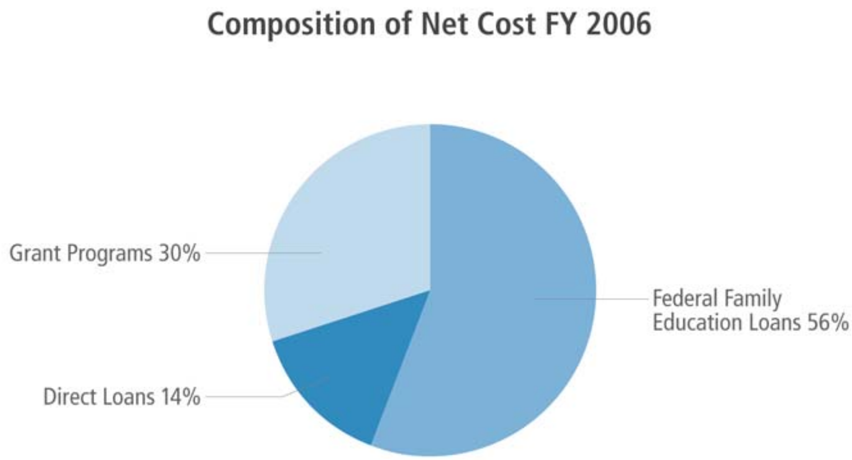
Statement of Changes in Net Position

Federal Student Aid's Net Position as of September 30, 2006 is $8.5 billion, which increased by $4.4 billion, compared to $4.1 billion at September 30, 2005. The increase was due primarily to higher unexpended appropriations for the Pell Grant Program. There was an increase in Pell Grant funding to eliminate the Pell Grant shortfall and an increase for the ACG program, a new program under HERA.

Statement of Net Cost

Federal Student Aid had total net costs of about $51 billion during FY 2006. In the FFEL Program, the total net cost was about $28.4 billion. In the Direct Loan program, total net costs were $7 billion. The grant programs had a total net cost of $15.6 billion. The gross costs are primarily composed of subsidy expenses and the funding of grants. Subsidy expenses are the estimated costs of funding the direct loans and loan guarantees. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows. Indirect costs are Departmental administrative costs including supplies, training costs, rent/lease agreements for Federal Student Aid occupied buildings, printer/fax/copier services, mail services and other costs allocated to each Federal Student Aid program as part of our effort to report full cost. There was an increase of approximately $19.9 billion in net costs incurred in FY 2006 compared to FY 2005. This was primarily due to increases in FFEL gross costs of $18.7 billion. Increases in upward re-estimates and subsidy transfers due to increased loan consolidation activity led to this increase. Also there were increases in

Direct Loan and Grants gross costs. The increase in gross costs for Direct Loans is due primarily to increased upward re-estimates and subsidy transfers due to increased loan consolidation activity. Gross costs were reduced by earned revenues for FFEL and Direct Loans.



Statement of Budgetary Resources

The Statement of Budgetary Resources compares the budgetary resources provided with the status or execution of those resources and shows the amount of net outlays. This statement shows that Federal Student Aid had $164.3 billion in combined budgetary resources, of which $47.4 billion remained un-obligated and not available at year-end. Federal Student Aid had total net outlays for FY 2006 of $25.1 billion. There was a decrease in total net outlays of $757 million comparing September 2006 to September 2005. The decreases in Direct Loan and Grants net outlays were greater than an offsetting increase in FFEL net outlays, resulting in an overall decrease in total net outlays for Federal Student Aid. There was a decrease in the net outlays for Direct Loans due to increased offsetting collections.

Statement of Financing

The Statement of Financing demonstrates the relationship between an entity's proprietary and budgetary accounting information by linking the net cost of operations (proprietary) with net obligations (budgetary) through the identification of key differences between the two statements. The statement identifies $29.7 billion of resources used to finance Federal Student Aid activities in FY 2006.

Significant budgetary resources used to finance items not part of net cost of operations include collections of principal and interest from borrowers; collections of subsidy for loan guarantees committed during the current period and adjustments to collections of subsidy for loan guarantees committed in prior periods; and disbursements for new loans and loan consolidations, default claims, and lender payments to commercial lenders.

Analysis of Federal Student Aid's Systems, Controls and Legal Compliance

Internal control is a major part of managing an organization. It comprises the plans, methods and procedures used to meet missions, goals and objectives and, in doing so, supports performance-based management. Internal control also serves as the first line of defense in safeguarding assets and preventing and detecting errors and fraud. In short, internal control, which is synonymous with management control, helps government program managers achieve desired results through effective stewardship of public resources.

Internal control should provide reasonable assurance that the objectives of the agency are being achieved in the following categories:

- Effectiveness and efficiency of operations, including the use of the entity's resources.
- Reliability of financial reporting, including reports on budget execution, financial statements, and other reports for internal and external use.
- Compliance with applicable laws and regulations.[1]

Federal Student Aid management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA). Federal Student Aid conducted its assessment of the effectiveness of internal control over the effectiveness and efficiency of its operations and compliance with applicable laws and regulations in accordance with OMB Circular A-123, *Management's Responsibility for Internal Control*. Based on the results of this evaluation, Federal Student Aid reported to Department Management that its internal controls over the effectiveness and efficiency of its operations and compliance with applicable laws and regulations, as of September 30, 2006, were operating effectively, and no material weaknesses were found in the design or operation of the internal controls.

In addition, Federal Student Aid conducted its assessment of the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular A-123, *Management's Responsibility for Internal Control*. The scope of Federal Student Aid's assessment included the following processes that impact the Department of Education's financial statements:

- Direct Loan servicing
- Direct Loan originations and disbursements
- Direct Loan consolidations
- Grants disbursements (Pell and campus-based)
- Financial closing and reporting (month-end closing, journal voucher processing, reconciliations)
- Financial partner invoicing and oversight
- FFEL guaranty agency reserve fund
- Institutional eligibility (Direct Loans and grants)
- Debt management
- General computer controls related to various agency systems
- Katrina response

[1] GAO Standards for Internal Control in the Federal Government, GAO/AIMD-00-21.3.1, November 1999, p. 4-5

Also, in participating in the Department's successful implementation of OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A requirements, Federal Student Aid established a more robust internal control framework that will be used in continuing efforts to monitor and improve internal controls. Please refer to the Department's Performance and Accountability Report for information related to the Department's compliance with the Federal Financial Management Improvement Act.

Improper Payment Information Act (IPIA) Reporting

The IPIA of 2002 and OMB's implementing guidance requires agencies to annually review all programs and activities to identify those susceptible to significant improper payments. The guidance defines significant improper payments as those in any particular program that exceed both 2.5 percent of program payments and $10 million annually. For each program identified as susceptible, agencies are required to report the annual amount of estimated improper payments, along with steps taken and actions planned to reduce them. Federal Student Aid achieved a "green" progress score on the September 30, 2006, PMA scorecard for Eliminating Improper Payments and status score of "yellow" for Eliminating Improper Payments for the same period.

OMB uses quarterly color-coded scorecards to monitor agencies' status and progress toward attaining the PMA program initiative goals. In conjunction with the requirements of the IPIA, a new key initiative, entitled *Eliminating Improper Payments,* summarizes the results of quarterly actions to ensure compliance with the IPIA.

Federal Student Aid measures and reports annual improper payment estimates for the Pell Grant and FFEL Programs. OMB automatically considers programs previously required to report under A-11, Section 57 as susceptible to significant improper payments, regardless of the established thresholds. Risk assessments conducted in FY 2006 indicated that other programs administered by Federal Student Aid are not at significant risk of improper payments.

For FY 2005, the preliminary rate for the FFEL error rate is 2.2%, based on an evaluation of the following information:

- Overpayments identified during Federal Student Aid's Financial Partners Service (FP) program reviews of guaranty agencies, lenders and loan servicers during FY 2005.
- Overpayments identified by independent public accountants (IPA) and third-party audit firms in Single Audit reports for guaranty agencies and lenders.
- Overpayments reported by the Department of Education's OIG in audits and reviews of guaranty agencies, lenders and loan servicers during FY 2005.
- Outstanding loan balance amounts at guaranty agencies, lenders and servicers selected for review by the OIG, IPAs and Federal Student Aid's FP.

For the Pell Grant program, the error rate from the FY 2005 Internal Revenue Service study is 3.48%.

During the fiscal year, the Inspector General issued an audit report that questioned payments made to an entity that participates in the FFEL Program. The findings cited in this report are under consideration by the Department. Until the matter is resolved, the potential impact, if any, on the Department's financial position is not possible to estimate.

Possible Future Effects of Existing Events and Conditions

Federal Student Aid's ability to fully implement the initiatives described in this report are impacted by external factors, including budget and policy considerations and unanticipated events. Federal Student Aid works closely with the Department and OMB to develop our administrative budget and ensure appropriate resources are allocated to support our strategic objectives.

Legislative and/or regulatory action may result in policy, resources or program changes requiring Federal Student Aid to revisit our current strategic plan. Specifically, the reauthorization of the HEA is scheduled to occur during this session of Congress. Once completed, Federal Student Aid will revise both our ***Annual Performance Plan*** and the ***Five-Year Plan*** to meet the new legislative and/or regulatory requirements.

Other external factors could also affect our ability to achieve the organization's objectives. For example, in August and September 2005, hurricanes Katrina and Rita caused extensive damage to the Gulf Coast region of the United States. As a result, Federal Student Aid mounted a large-scale response effort to assist our customers impacted by the unprecedented destruction of hurricanes Katrina and Rita. We are unable to anticipate the full cost or impact to Federal Student Aid's strategic objectives as a result of our long-term commitment to other similar unforeseen events.

Limitations of Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b).

While the statements have been prepared from the books and records of the entity in accordance with generally accepted accounting principles (GAAP) for federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

ANNUAL PROGRAM PERFORMANCE REPORT

Annual Program Performance

During FY 2006, Federal Student Aid made significant accomplishments, as well as progress in meeting our performance standards as outlined in the FY 2006 – FY 2010 Five-Year Plan. The information presented herein provides details of our achievements, by objective. Under each objective below, we have identified the corresponding Performance Standard, as well as the organization's progress in meeting the stated target. Unless otherwise noted, these performance standards and their respective ratings are based on criteria established by Federal Student Aid.

Objective 1: Integrate Federal Student Aid systems and provide new technology solutions.

- Awarded a four-year contract for the development of the IPM. The IPM project will integrate, modernize and reengineer Federal Student Aid monitoring and oversight functions and provide better customer service to trading partners using a single sign-on process to multiple Federal Student Aid systems. IPM will provide the ability to view data holistically about a trading partner's activities and needs. The first phase of the project will be implemented in FY 2008. The new contract will save approximately $5.4 million during the contract term.
- Awarded a ten-year contract to operate the VDC. The VDC houses the basic computer systems that support and operate delivery of Title IV student aid. The VDC also is a hub that connects several other data and processing centers into a single, logical servicing operation. The new contract includes considerable flexibility to expand in the future at little additional cost and includes special provisions to handle peak processing volumes during the year. The new contract will save over $150 million during the contract term.
- Integrated three new systems into the security architecture infrastructure. The Security Architecture system of software and hardware is the principal infrastructure Federal Student Aid will use to control access to its systems and data, and to provide single sign-on for our trading partners. It will also be the foundation for rollout of the PMA e-Authentication initiative during the FY 2007–2012 period, eventually reaching 75 million past and present aid recipients.
- Completed the enterprise portal strategy for the consolidation of 73 existing Web sites.
- Ranked 4th of all government agencies in OMB's Enterprise Architecture assessments.
- Attained a "green" score on the PMA scorecard for e-Gov initiatives and received the Department of Labor's Partner Appreciation Award. As a major contributor to these milestones, Federal Student Aid led the Department's efforts for e-Authentication (agreed to enable two Department systems), GovBenefits (highlighting 56 Department programs on this government-wide site), Business Gateway and USA Services.
- Completed the automation of the monthly project scorecard process. This improves the accessibility of project status information across the organization, while providing an integrated, efficient way to capture status data and allow quick and accurate consolidation and reporting.
- Continued identifying requirements and completed a technical proof of concept for the ADvance solution, an initiative to modernize and integrate the organization's core front-office business functions through the reengineering, retirement and replacement of existing aid delivery systems.
- Continued design of the Common Services for Borrowers initiative, a solution that consolidated Federal Student Aid's back-office systems for Direct Loan Servicing, Consolidation and Collections into a single integrated solution.
- Completed the conceptual design and high-level functional specifications for the Information Framework solution, an initiative to improve Federal Student Aid's business operations and data management functions by centralizing data-transformation services, serving as a centrally accessible record for shared data, and increasing the standardization, quality and traceability of the master data shared among Federal Student Aid systems.

Performance Standards and Results

The following performance standards were established to measure our success in achieving our key integration initiatives. Success is predicated on the timely completion of all scheduled project deliverables in the design, development and implementation phases of the four main systems integration initiatives as described below.

Objective 1:
Integrate Federal Student Aid systems and provide new technology solutions.

Integration Initiative	FY 2006 Target	FY 2006 Actual	Performance
Common Services for Borrowers[1]	Development	Design	Target Not Met
ADvance[2]	Development	Design	Target Not Met
Integrated Partner Management	Design	Design	Target Met
Information Framework	Design	Design	Target Met

[1] The Common Services for Borrowers project did not meet its projected target due to delays in meeting established timelines.
[2] The ADvance project did not meet its projected target due to a change in the acquisition strategy.

Objective 2: Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement.

- Achieved a “green” progress score on the PMA scorecards for Financial Management and Eliminating Improper Payments and a “yellow” progress score for Credit Management, as of September 30, 2006. Achieved status scores of “green” for Financial Management, “yellow” for Eliminating Improper Payments and “red” for Credit Management also, as of September 30, 2006.
- Developed and will publish the first iteration of the Cumulative Lifetime Default Rate for the Title IV student loan portfolio.
- Achieved a continued low rate of 5.1% for the NCDR for FY 2004.
- Achieved FY Direct Loan and FFEL default recovery goals of 19% and 19.3%, respectively.
- Developed and implemented standardized processes across Federal Student Aid’s 10 regional offices for reviewing the over 6,000 schools that participate in the Title IV programs. This implementation included the training of nearly 300 school program review staff.
- Developed and implemented a standard model for evaluating VFA for cost neutrality. This model is being used to evaluate the existing five VFA agreements and for evaluating new VFA requests. This model enabled Federal Student Aid to determine that four of the existing agreements were not cost neutral; and as a result, they are being renegotiated.
- Achieved an unqualified audit opinion for FY 2006 for the fifth consecutive year.
- Developed and implemented a management tool to evaluate the financial condition, including reserve ratios and fund balances, of guaranty agencies. As a result, this year, eight agencies are required to submit management plans for improving their financial health to Federal Student Aid.
- Improved the monitoring of publicly traded schools. These schools represent about 4% of all schools, but they receive over 10% of all Title IV funding. We developed new strategies, including targeted on-site reviews and a more critical analysis of their financial statements, to address this potential risk exposure.

- Successfully implemented OMB Circular A-123, *Management's Responsibility for Internal Control,* Appendix A and sound financial management controls. In addition to complying with OMB requirements, Federal Student Aid established an internal control framework to be leveraged for continuous internal-control improvement.
- Volunteered to complete a 100% physical inventory (which was completed within two weeks of making the commitment) of assets in response to an unanticipated issue with the Department's Information Technology asset management inventory.
- Successfully upgraded FMS to Oracle Federal Financials application version 11i and database version 10g. This upgrade was completed on time and on budget and with no negative impact to our over 3,200 lenders and 35 guaranty agencies customers. Federal Student Aid was the first government entity to successfully complete an upgrade of this configuration.

Performance Standards and Results

The following performance standards were established to gauge our success in improving program integrity, while reducing the vulnerability of the Title IV programs to fraud, waste and abuse. Our success relies on maintaining "green" status on the PMA, continuing to achieve low default rates and increasing the recovery rate.

<table>
<tr><td colspan="5">Objective 2:
Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement.</td></tr>
<tr><th>Metric</th><th>FY 2006 Target</th><th colspan="2">FY 2006 Actual</th><th>Performance</th></tr>
<tr><td>PMA score for financial management*</td><td>Green</td><td colspan="2">Green</td><td>Target Met</td></tr>
<tr><td>PMA score for improper payments*</td><td>Yellow</td><td colspan="2">Yellow</td><td>Target Met</td></tr>
<tr><td rowspan="5">Cumulative Lifetime Default Rate –
Title IV Student Loan Portfolio</td><td rowspan="5">Develop Baseline</td><td>FY 1999</td><td>12.24%</td><td rowspan="5">Target Met</td></tr>
<tr><td>FY 2000</td><td>11.82%</td></tr>
<tr><td>FY 2001</td><td>9.93%</td></tr>
<tr><td>FY 2002</td><td>7.82%</td></tr>
<tr><td>FY 2003</td><td>5.48%</td></tr>
<tr><td>Cohort Default Rate</td><td>< 6%</td><td colspan="2">5.1%</td><td>Target Met</td></tr>
<tr><td>Direct Loan Default Recovery Rate</td><td>19.0%</td><td colspan="2">19.0%</td><td>Target Met</td></tr>
<tr><td>FFEL Default Recovery Rate</td><td>19.3%</td><td colspan="2">19.4%</td><td>Target Met</td></tr>
</table>

*See www.results.gov for definitions, trend and PMA scorecard support for both financial management and improper payments.

Objective 3: Reduce program administration costs.

- Completed the development of the unit cost baseline through our ABC Model. This baseline was used to help develop both the FY 2007 and FY 2008 Federal Student Aid budget submissions.
- Continued to manage and control operating expenses through efficiencies, productivity gains, and capital savings. Our operating expense budget has been reduced to 44% of the total budget vs. 47% of the total budget in FY 2005.

- Awarded a ten-year contract to operate the VDC. The new contract will save over $150 million during the contract term.
- Awarded a four-year contract for the development of the IPM. The new contract will save approximately $5.4 million during the contract term.
- Developed and adopted a coordinated technical and business management approach to plan, execute and manage acquisitions while ensuring the highest value of service is received for the lowest possible cost while allowing program management flexibility across all business functions.
- Increased business analysis capabilities and better procurement planning supported by thorough market research resulted in several highly leveraged contract competitions that were negotiated in Federal Student Aid's favor. The projected Return on Investment (ROI) or other savings for several contracts include:
  - VDC Renegotiation - $28 million ROI total for FY 2006 and FY 2007
  - VDC Re-compete - Over $150 million ROI total from FY 2006 through FY 2016
  - IPM - $5.4 million ROI total from FY 2008 through FY 2011
- Significantly increased small-business participation through better internal controls, communications and management emphasis and support. An example includes the Information Technology Support Services (ITSS) contract, under which Blanket Purchasing Agreements (BPAs) to 18 small businesses were awarded.

Performance Standards and Results

Performance standards were established to measure our ability to control costs in an environment of increasing workloads. Success relies on achieving economies of scale in our application, delivery, servicing and collection activities.

Objective 3:
Reduce program administration costs.

Metric	FY 2006 Target	FY 2006 Actual	Performance
Reduce electronic FAFSA direct unit costs	Develop Baseline	$5.04	Target Met
Reduce origination and disbursement direct unit costs	Develop Baseline	$4.42	Target Met
Reduce Direct Loan Servicing direct unit costs	Develop Baseline	$20.95	Target Met
Reduce Collections direct unit costs	Develop Baseline	$0.14	Target Met

Objective 4: Improve human capital management.

- Successfully developed a baseline of data to measure the use of training resources to develop a highly skilled workforce to ensure competency in mission-critical skills/knowledge. This work first involved reaching agreement on mission-critical skills and developing an approach to collecting the data. Federal Student Aid identified four key, mission-critical skills necessary to accomplish its work: 1) supervision/leadership, 2) acquisitions, 3) project management and 4) Federal Student Aid business knowledge. In each of these areas, we identified the target population to be trained in FY 2006 and the training requirements for that population. The baseline was calculated based on the percentage of the target that was met.
- Successfully sought and was granted (on January 9, 2006) additional delegations of human resources authority from the Secretary, with respect to operations, as we interact and collaborate with the rest of the

Department, including OM. Federal Student Aid developed an implementation plan, as required, within 30 days after receiving the delegations. All delegated functions have been successfully transferred from OM and were transitioned on a twice-accelerated schedule (vs. the original plan) at the request of OM. In order to complete this transition successfully, Federal Student Aid had to, among other things, obtain Delegated Examining Unit (DEU) training and certification, secure Servicing Personnel Office (SPO) status, complete Federal Personnel and Pay System (FPPS) Security and SPO training and complete EdHIRES training. Finally, two significant innovations were launched as part of this implementation—the streamlining of the hiring processes, as defined in the Extreme Hiring Makeover, and the conversion from paper to electronic Official Personnel Files (eOPFs).

- Continued its progress in institutionalizing sound performance management using the Department's Five-Tier Performance Management System and holding managers accountable for accurately and fairly rating individual performance. The ongoing goal is to clearly differentiate between the five different levels of performance and the delivery of real results. Our focused efforts have presented a more accurate portrait of performance within Federal Student Aid, with about 14.6% of staff being rated Outstanding and 34% Highly Successful in FY 2006.
- Successfully established a new Federal Student Aid Executive Management coordinating structure and realigned large segments of the organization to accomplish the following key objectives:

  1. Improve coordination and communication among Federal Student Aid business channels.
  2. Consolidate business operations to ensure consistency, efficiency and effectiveness among those business units with operational responsibilities.
  3. Increase focus on Program Integrity (i.e., school oversight, monitoring and compliance functions) and improve the coordination, consistency and efficiency of our oversight activities.
  4. Increase focus on aid awareness, outreach and the "student view" to improve our services to the most important customer, the student, and enhance and elevate our outreach activities to the many communities we serve, especially the underserved communities.
  5. Align performance-management functions to ensure enterprise view of contracts, project management, risk management and performance-management reporting.
  6. Align the communications office with the human resources, employee training, and facilities-management functions to improve the coordination and delivery of these services to staff.

Performance Standards and Results

The performance standard for improving human capital management measures our ability to maintain a skilled and knowledgeable workforce. Specifically, the performance measure will identify our mission-critical competencies, identify where current or potential weaknesses exist and identify training plans for individuals to further develop competency/skills/knowledge.

<table>
<tr><td colspan="4">Objective 4:
Improve human capital management.</td></tr>
<tr><th>Metric</th><th>FY 2006 Target</th><th>FY 2006 Actual</th><th>Performance</th></tr>
<tr><td rowspan="4">Use training resources to develop a highly skilled workforce to ensure competency in mission-critical skills/knowledge</td><td rowspan="4">Develop Baseline</td><td>Leadership
Train 100% New Supervisors
Train 52% Current Supervisors</td><td rowspan="4">Target Met</td></tr>
<tr><td>Acquisitions
Train 100% Contracting Officials</td></tr>
<tr><td>Project Management
Train 100% Key IT Project Managers</td></tr>
<tr><td>Federal Student Aid Business Knowledge
Train 90% New Employees
Train 10% School Compliance Officials
Train 40% General Workforce</td></tr>
</table>

Objective 5: Improve products and services to provide better customer service.

- The FY 2006 ACSI ratings for Federal Student Aid's highest volume products and services—including Direct Loan Servicing, *FAFSA on the Web*, COD and LaRS—score in the "Excellent" and "Good" range. The COD system received an ACSI score of 77, an 11-point gain since the ACSI was originally conducted on COD in FY 2003. Federal Student Aid products score higher than the federal government aggregate and on par with private sector organizations, such as Dell Incorporated, Microsoft Corporation, and Target Corporation, and financial services companies, such as JP Morgan Chase, Bank of America and Wells Fargo. The slight fluctuations in some of the FY 2006 scores from last year were deemed to be statistically insignificant by ACSI.
- Launched a multi-year enterprise communications strategy in FY 2005 to better articulate the benefits of postsecondary education, raise awareness of federal student aid programs and improve consistency across all communications to its many stakeholders, including currently underserved communities. In addition, this strategy establishes partnerships with organizations at national, regional and local levels that have the common goal of promoting awareness of and access to aid for postsecondary education. In FY 2006, Federal Student Aid began full-scale implementation of this strategy, launching a new Federal Student Aid brand and incorporating it across multiple points of presence. In addition, we began a comprehensive public service campaign utilizing media, print and Web executions to increase Federal Student Aid outreach to targeted, underrepresented populations.

Performance Standards and Results

The following performance standards were established to measure our success in meeting and exceeding customer service goals. Specifically, success is realized with continuous improvement in our customer satisfaction scores for our four main systems.

Objective 5:
Improve products and services to provide better customer service.

Metric (In percentages)	FY 2006 ACSI Benchmark[1]	Revised FY 2006 Target[2]	FY 2006 Actual	Performance[3]
Student aid application	75	83	80	Target Not Met
School origination and disbursement	68	76	77	Target Met
Lender payment processing	68	74	71	Target Not Met
Direct Loan borrower servicing	75	77	79	Target Met

[1] ACSI Benchmarks are the average score for private companies in a comparable industry sector.
[2] Federal Student Aid performance targets, established last year and included in the FY 2006 – 2010 Five-Year Plan to measure customer service, were delineated in percentile rank. This was done to provide a common measure of customer satisfaction, regardless of the method or company used to conduct the customer satisfaction surveys. Unfortunately, because it was discovered that so few companies are included in the ACSI sector benchmark averages, the percentile rank does not accurately reflect true performance. For example, a single-point change in the ACSI score of *FAFSA on the Web* resulted in a 21% change in percentile ranking.

To establish a better and more representative performance standard to measure customer satisfaction with Federal Student Aid products and services, we have updated our performance measures and targets based on actual ACSI sector averages. If, in the future, we utilize a different gauge of customer satisfaction, we will update our performance standards accordingly.

[3] In FY 2006, Federal Student Aid exceeded its revised customer satisfaction targets for school origination and disbursement and Direct Loan borrower servicing. However, Federal Student Aid did not meet its revised customer satisfaction targets for online student aid application processing or lender payment processing.

Legislative and Regulatory Recommendations

Key among Federal Student Aid's mission responsibilities is the task of developing legislative recommendations. These recommendations customarily center on improving and simplifying the Title IV programs, minimizing administrative costs and improving program integrity. Our recommendations inform the Department's policymaking process, including its activities and decisions related to the reauthorization of the HEA.

These activities are usually accomplished by direct contact with colleagues in the Department's Office of Postsecondary Education (OPE) at both the senior policy level and at a staff level. Federal Student Aid also provides policy decision input in a significant way to other offices, including to senior staff in the Secretary's Office and to OMB. These efforts, while primarily carried out by Federal Student Aid's Policy Liaison and Implementation Staff, also involve other Federal Student Aid offices and senior managers. While a portion of this policy advising is accomplished on an ongoing informal daily basis, Federal Student Aid staff contributed to policy decision-making in a more formalized way for policy decisions related to –

- A set of recommendations for reauthorization of the HEA
- Activities in reaction to the 2005 gulf hurricanes
- Implementation of the changes made to the Title IV programs by HERA and other legislation
- Activities related to issues of lender benefits in the student loan program (e.g., 9.5 percent special allowance)
- Simplification of the Title IV programs
- Legislation to implement a data match with the IRS
- Development of regulations
- The negotiated rulemaking process
- Minimizing improper payments and other risk mitigation activities

Federal Student Aid will continue to identify new business processes and procedures, innovative system solutions, best-practice risk management approaches and ground-breaking contracting solutions that help reduce the cost of administering the Title IV programs, as well as limit the vulnerability of the Title IV programs to fraud, waste, abuse and mismanagement. We will also continue to identify, propose and implement improvements to the personnel and procurement flexibilities afforded us in our PBO legislation.

Annual Bonus Awards

At the end of FY 2006, there were 52 Federal Student Aid senior managers. In addition, there are 15 senior managers who have achieved Senior Executive Service status. Six of the 52 senior managers and two of the 15 Senior Executive Service staff serve on the Federal Student Aid Executive Management Team and report directly to the Chief Operating Officer. The remaining 46 senior managers and 13 Senior Executive Service staff serve in a variety of senior positions and capacities within Federal Student Aid.

Ratings and awards for 42 of the 46 senior managers who do not serve on the Executive Management Team were approved at the time of this writing as follows: 38.1% achieved a performance rating of Outstanding, 50.0% achieved a performance rating of Highly Successful, 9.52% achieved a rating of Successful and 2.38% were not eligible for rating. Award amounts for those achieving an Outstanding rating ranged from a low of $4,701 to a high of $10,000, with a median award of $9,675. Award amounts for those achieving a Highly Successful rating ranged from a low of $3,270 to a high of $10,000, with a median award of $6,580. Those receiving a rating of Successful were not eligible for an award.

FY 2006 performance ratings and bonuses for the six senior managers who serve on Federal Student Aid's Executive Management Team and four of the 46 other senior managers were not finalized at the time of this publication. Additionally, FY 2006 performance ratings and bonuses for the 15 Senior Executive Service staff, including the two who serve on Federal Student Aid's Executive Management team, were not finalized at the time of this publication.

The Chief Operating Officer's performance award for FY 2006 is expected to be consistent with the average of bonuses for the past three performance years of $65,833. It is also anticipated that performance bonuses for the six Executive Management Team senior managers and the four remaining other senior managers will be relatively consistent with the ranges for FY 2005 bonuses.

Possible Future Effects of Existing Events and Conditions

Federal Student Aid's ability to fully implement the initiatives described in this report is impacted by external factors, including budget and policy considerations and unanticipated events. Federal Student Aid works closely with the Department and OMB to develop our administrative budget and ensure appropriate resources are allocated to support our strategic objectives.

Legislative and/or regulatory action may result in policy, resources or program changes requiring Federal Student Aid to revisit our current strategic plan. Specifically, the reauthorization of the HEA is scheduled to occur during this session of Congress. Once completed, Federal Student Aid will revise both our ***Annual Performance Plan*** and the ***Five-Year Plan*** to meet the new legislative and/or regulatory requirements.

Other external factors could also affect our ability to achieve the organization's objectives. For example, in August and September 2005, hurricanes Katrina and Rita caused extensive damage to the Gulf Coast region of the United States. As a result, Federal Student Aid mounted a large-scale response effort to assist our customers impacted by the unprecedented destruction of hurricanes Katrina and Rita. We are unable to anticipate the full cost or impact to Federal Student Aid's strategic objectives as a result of our long-term commitment to other similar unforeseen events.

The following are specific examples of Federal Student Aid's response in FY 2006 to unanticipated events:

- **Hurricanes Katrina and Rita:**
  - Provided outreach and assistance to impacted schools and students;
  - Provided outreach to FFEL lenders, servicers, guaranty agencies and borrowers;
  - Created specialized units within Federal Student Aid customer call centers;
  - Created dedicated toll-free phone numbers;
  - Created a consolidated source Web site to provide guidance and communications to our customers concerning issues related to hurricanes Katrina and Rita;
  - Created a special email address and mailbox for submission of questions;
  - Issued Federal Student Aid guidance and policy related to issues impacting students, parents, schools, financial institutions, guaranty agencies and borrowers;
  - Ensured monitoring and oversight of closed schools and impacted schools, lenders, and guaranty agencies to ensure proper administration of Title IV funds in accordance with all emergency guidance that was issued to ensure no improper payments; and
  - Implemented strict financial controls around relief aid provided to postsecondary schools in accordance with OMB guidance.
- **Implement HERA of 2005:**
  - Successfully implemented the provisions of the HERA less than five months after its enactment. This legislation contained over 65 provisions that impacted almost every Federal Student Aid business function and system. In total, 10 separate systems and their associated business processes were either developed or modified; 50 operationally related electronic announcements were developed and issued; nearly all print and electronic media about the Title IV programs were modified; and all customer contact center scripts were modified as were all Title IV training programs.
  - HERA included two new grant programs, the ACG and SMART Grant programs, and one new loan program, the Student PLUS Loan, for which systems, business processes, communications and training materials needed to be developed and implemented. The implementation of the new grant programs was one of the Secretary's highest priorities. Federal Student Aid implemented both programs by the required July 1 date, including the development and delivery of training sessions to

over 10,000 financial aid administrators and other program participants. As of September 15, 2006, over 609,000 students had submitted their eligibility information for ACG grants and schools had distributed nearly $13 million to an estimated 27,000 students. In addition, schools had distributed SMART grants in excess of $14 million to an estimated 7,528 students.

- **Pandemic Flu Preparation and Readiness:**
  - Federal Student Aid added this item to its 2006 Performance Plan when it was newly identified as a national initiative and high Departmental priority. We developed a detailed project plan outlining the actions necessary to ensure we are properly prepared for a pandemic flu outbreak. Federal Student Aid's project plan was developed prior to the Department's guidance and was subsequently adopted by the Department as a basis for the Department-wide project plan. In March, Federal Student Aid developed a Communication Test Plan and Pandemic Flu "what if" Test Scenario. The Test Plan was successfully tested in March and was used as a basis for the Department's subsequent test in September. The Test Scenario required variations to the Federal Student Aid COO succession plan and availability of critical staff. Telecommunication equipment was tested along with network-drive accessibility, Internet access and home/cell phone numbers. We also ensured that the proper emergency supplies to deal with an onset of pandemic flu were procured and on hand should they be needed. Additionally, we developed a prioritization for Federal Student Aid staff for receiving immunizations should a pandemic occur. Finally, we developed guidance (pending approval and issuance) for postsecondary institutions and other Title IV program participants to assist them in the event that a pandemic flu outbreak impacts their ability to administer the Title IV student assistance programs.

Report of the Federal Student Aid Ombudsman

The Federal Student Aid Office of the Ombudsman, now in its seventh year of operations, was established by the 1998 Amendments to the HEA. The office uses informal dispute-resolution processes to address complaints from those who receive assistance through Title IV financial aid programs. By working with institutions of higher education, lenders, guaranty agencies, loan servicers and other participants in student aid programs, and by analyzing complaint data from the Ombudsman Case-Tracking System, the office identifies broad systemic issues impacting Title IV programs.

Information about the Federal Student Aid Office of the Ombudsman is disseminated to the industry and borrowers throughout the student aid life cycle from application through repayment. The office of the Ombudsman Web site at www.ombudsman.ed.gov is designed to help individuals resolve loan problems independently, find useful student aid information and resources and submit complaints electronically for Ombudsman analysis and resolution. The office produces other materials for the higher education community (e.g. the monthly Ombudsman Newsletter) regarding Ombudsman services and industry news, meets with guaranty agencies and others to address issues common to the industry and produces tailored reports for individual agency use.

Since its inception, the Federal Student Aid Ombudsman Office has handled over 100,000 complaints, including 16,893 in FY 2006, an increase of 2,118 over FY 2005. The office resolved more than 72 percent of FY 2006 issues within three days of the initial issue receipt, and took an average of 90 days to resolve 4,663 issues requiring additional research. Of the cases requiring additional effort, individual borrowers had an average of eight loans. Only 17 percent of those borrowers' loans are in default, 37 percent of the loans have been in repayment less than five years, and 72 percent of those loans are FFEL Program Loans.

In FY 2006, loan consolidation was the most common issue across all 4,663 research cases. Almost one in four of all research cases involved a question or disagreement related to consolidation. The increase in loan interest rates and changes authorized by the HERA of 2005 were contributing factors to the frequency of loan consolidation research cases. Other prevalent Ombudsman research issues related to borrowers' account balances, loan cancellation/discharge provisions, repayment plans/amounts and default. In aggregate, these top five issues accounted for two thirds of the 4,663 total research case volume. The office also responded to individual inquiries from victims of hurricanes Katrina and Rita.

The Office of the Ombudsman measures effectiveness by obtaining customer feedback through independently conducted telephone surveys. Closed cases are chosen at random, and customers are asked to rate service accessibility, Ombudsman representatives' knowledge, timeliness of case resolution, level of satisfaction with the resolution and overall service. On a scale of 1 to 5, with 5 the highest rating, survey results are calculated weekly and cumulatively. Only ratings of 4.0 or higher meet the Ombudsman customer satisfaction performance goal. That standard was exceeded every week of the fiscal year, resulting in an average FY 2006 customer satisfaction rating of 4.50.

MESSAGE FROM THE CHIEF FINANCIAL OFFICER

Message from the Chief Financial Officer

I am pleased to report that for the fifth consecutive year, Federal Student Aid has received an unqualified opinion on our consolidated financial statements. This opinion demonstrates Federal Student Aid's commitment to the highest standards of management, financial responsibility and program integrity. For the fourth consecutive year, the auditors identified no material weaknesses.

This year, the Higher Education Reconciliation Act of 2005 created two new student grant programs with an effective date as early as July 1, 2006. These programs, the Academic Competitiveness Grant Program and the National Science and Mathematics Access to Retain Talent Grant Program, encourage students to pursue college majors that are in high demand in the global economy.

To assist our customers impacted by the unprecedented destruction of hurricanes Katrina and Rita, Federal Student Aid reallocated unexpended campus-based program funds, during FY 2006, to institutions of higher education located in areas that were directly affected. Aid discharge relief to affected institutions in the amount of $29 million was granted. Federal Student Aid is also involved in the deployment of other sources of hurricane relief aid to its education partners. Federal Student Aid delivered hurricane Title IV relief funds to impacted institutions, lenders and guaranty agencies in a post-hurricane environment, developed policies and procedures for the changes required by enacted legislation, gathered information for monitoring progress and tested the adequacy of internal controls over the end-to-end process.

Continued improvement of the integrity of the student aid programs was manifested in the second quarter 2006 President's Management Agenda (PMA) Improper Payments reporting, when the Department was upgraded to a "yellow" on status and reflected as "green" on progress. An additional credit management scorecard, *Improve Credit Management,* was added in FY 2006. For such, the current status is "red," and the progress is "yellow."

Through the efforts and teamwork of Federal Student Aid management and staff, as well as the cooperative efforts of the Office of Inspector General (OIG) and the independent auditors, Federal Student Aid continues to make progress on two previous reportable conditions: credit reform estimation and controls surrounding information systems. During the next fiscal year, we are committed to building on the improvements made during FY 2006 in these two areas.

Federal Student Aid, working with the Department, implemented an integrated process in FY 2006 to support a Department-wide assurance statement on the effectiveness of internal controls over financial reporting, as of June 30, 2006, so as to satisfy the new requirements of OMB Circular A-123, *Management's Responsibility for Internal Controls,* Appendix A. This process required Federal Student Aid to conduct internal risk assessments, document organizational and process hierarchies, document Federal Student Aid's entity and process level control libraries, assess the effectiveness of Federal Student Aid controls over financial reporting, coordinate remediation activities and retesting and report on status and results internally and to the Department. The results of this assessment effort are described further in "Analysis of Federal Student Aid's Systems, Controls and Legal Compliance" section.

Federal Student Aid's five core strategic objectives listed below provide the framework for continuous improvement. Significant progress was realized in each area during this fiscal year with improvements expected to continue in the coming fiscal year.

1. To integrate Federal Student Aid systems and provide new technology solutions;
2. To improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement;
3. To reduce program administration costs;
4. To improve human capital management; and
5. To improve products and services to provide better customer service.

We look forward to working with the OIG and our auditors to ensure Federal Student Aid's continued commitment to superior business practices and our success in meeting the goals and objectives of the Performance-Based Organization legislation.

Victoria L. Bateman, CPA, CGFM
Chief Financial Officer

November 10, 2006

Principal Financial Statements and Notes to Principal Financial Statements

United States Department of Education
Federal Student Aid
Consolidated Balance Sheet
As of September 30, 2006 and 2005

(Dollars in Millions)

		Fiscal Year 2006		Fiscal Year 2005
Assets:				
Intragovernmental:				
Fund Balance with Treasury (Note 2)	$	67,576	$	37,876
Total Intragovernmental		67,576		37,876
Cash and Other Monetary Assets (Note 4)		566		888
Accounts Receivable, Net (Note 3)		31		131
Credit Program Receivables, Net (Note 5)		106,383		107,602
General Property, Plant and Equipment, Net		14		7
Other Assets		1		1
Total Assets	**$**	**174,571**	**$**	**146,505**
Liabilities:				
Intragovernmental:				
Accounts Payable			$	1
Debt (Note 6)	$	105,430		104,372
Guaranty Agency Federal and Restricted Funds Due to Treasury (Note 4)		566		888
Payable to Treasury (Note 5)		5,519		5,166
Other Intragovernmental Liabilities (Note 7)		2		2
Total Intragovernmental		111,517		110,429
Accounts Payable		609		549
Accrued Grant Liability (Note 8)		1,250		635
Liabilities for Loan Guarantees (Note 5)		52,453		30,611
Other Liabilities (Note 7)		255		231
Total Liabilities	**$**	**166,084**	**$**	**142,455**
Commitments and Contingencies (Note 15)				
Net Position:				
Unexpended Appropriations - Earmarked Funds				
Unexpended Appropriations - Other Funds	$	13,639	$	8,597
Cumulative Results of Operations - Earmarked Funds				
Cumulative Results of Operations - Other Funds		(5,152)		(4,547)
Total Net Position (Note 9)	**$**	**8,487**	**$**	**4,050**
Total Liabilities and Net Position	**$**	**174,571**	**$**	**146,505**

The accompanying notes are an integral part of these statements.

United States Department of Education
Federal Student Aid
Consolidated Statement of Net Cost
For the Years Ended September 30, 2006 and 2005

(Dollars in Millions)

	Fiscal Year 2006	Fiscal Year 2005
Program Costs		
Enhancement of Postsecondary and Adult Education		
Gross costs	$ 58,803	$ 38,007
Less: Earned Revenue	7,772	6,845
Net Program Costs	51,031	31,162
Total Program Costs	**$ 51,031**	**$ 31,162**
Net Cost of Operations (Note 10)	**$ 51,031**	**$ 31,162**

The accompanying notes are an integral part of these statements

United States Department of Education
Federal Student Aid
Consolidated Statement of Changes in Net Position
For the Years Ended September 30, 2006 and 2005

(Dollars in Millions)

	Fiscal Year 2006		Fiscal Year 2005	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Beginning Balances				
Beginning Balances - Earmarked Funds				
Beginning Balances - All Other Funds	**$ (4,547)**	**$ 8,597**	**$ (3,062)**	**$ 9,181**
Beginning Balances, as adjusted - Earmarked Funds				
Beginning Balances, as adjusted - All Other Funds	$ (4,547)	$ 8,597	$ (3,062)	$ 9,181
Budgetary Financing Sources:				
Appropriations Received				
Appropriations Received - Earmarked Funds				
Appropriations Received - All Other Funds		$ 56,221		$ 31,863
Other Adjustments (rescissions, etc)				
Other Adjustments (rescissions, etc) - Earmarked Funds				
Other Adjustments (rescissions, etc) - All Other Funds		(861)	$ (1)	(804)
Appropriations Used				
Appropriations Used - Earmarked Funds				
Appropriations Used - All Other Funds	$ 50,318	(50,318)	31,643	(31,643)
Nonexpenditure Financing Sources - Transfers-Out				
Nonexpenditure Financing Sources - Transfers-Out - Earmarked Funds				
Nonexpenditure Financing Sources - Transfers-Out - All Other Funds	(11)		(5)	
Other Financing Sources:				
Imputed Financing from Costs Absorbed by Others				
Imputed Financing from Costs Absorbed by Others - Earmarked Funds				
Imputed Financing from Costs Absorbed by Others - All Other Funds	$ 8		$ 9	
Others				
Others - Earmarked Funds				
Others - All Other Funds	111		(1,969)	
Total Financing Sources	$ 50,426	$ 5,042	$ 29,677	$ (584)
Total Financing Sources - Earmarked Funds				
Total Financing Sources - All Other Funds	$ 50,426	$ 5,042	$ 29,677	$ (584)
Net Cost of Operations				
Net Cost of Operations - Earmarked Funds				
Net Cost of Operations - All Other Funds	**$ (51,031)**	**$**	**$ (31,162)**	
Net Change				
Net Change - Earmarked Funds				
Net Change - All Other Funds	$ (605)	$ 5,042	$ (1,485)	$ (584)
Ending Balances - Earmarked Funds (Note 9)	**$ (0)**	**$ (0)**	**$ (0)**	**$ (0)**
Ending Balances - All Other Funds (Note 9)	**$ (5,152)**	**$ 13,639**	**$ (4,547)**	**$ 8,597**

The accompanying notes are an integral part of these statements

United States Department of Education
Federal Student Aid
Combined Statement of Budgetary Resources
For the Years Ended September 30, 2006 and 2005

(Dollars in Millions)

	Fiscal Year 2006		Fiscal Year 2005	
	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts
Budgetary Resources:				
Unobligated balance, brought forward, October 1:	$ 1,429	$ 22,817	$ 1,567	$ 15,128
Recoveries of prior year Unpaid Obligations	1,005	3,450	1,024	1,973
Budgetary Authority:				
Appropriations	56,221	105	31,813	1
Borrowing Authority		35,073		32,170
Spending authority from offsetting collections (gross):				
Earned				
Collected	1,967	77,367	3,073	49,510
Change in Receivables from Federal Sources				(2)
Change in unfilled customer orders				
Without advance from Federal Sources		(4)		34
Subtotal	$ 58,188	$ 112,541	$ 34,886	$ 81,713
Permanently not available	(2,861)	(32,230)	(3,507)	(24,678)
Total Budgetary Resources (Note 12)	**$ 57,761**	**$ 106,578**	**$ 33,970**	**$ 74,136**
Status of Budgetary Resources:				
Obligations incurred: (Note 12)				
Direct	$ 53,374	$ 60,088	$ 32,541	$ 51,319
Subtotal	$ 53,374	$ 60,088	$ 32,541	$ 51,319
Unobligated Balances:				
Apportioned	3,437		31	
Subtotal	$ 3,437	$	$ 31	$
Unobligated Balance not available	950	46,490	1,398	22,817
Total Status of Budgetary Resources	**$ 57,761**	**$ 106,578**	**$ 33,970**	**$ 74,136**
Change in Obligated Balance:				
Obligated balance, net				
Unpaid obligations, brought forward, October 1	$ 9,225	$ 10,763	$ 9,800	$ 7,780
Less: Uncollected customer payments from Federal Sources, brought forward, October 1		34		2
Total, unpaid obligated balance, brought forward, net	$ 9,225	$ 10,729	$ 9,800	$ 7,778
Obligation Incurred net (+/-)	53,374	60,088	32,541	51,319
Less: Gross Outlays	50,010	54,460	32,092	46,364
Less Recoveries of prior year unpaid obligations, actual	1,005	3,450	1,024	1,973
Change in uncollected customer payments from Federal Sources (+/-)		4		(34)
Obligated Balance, net, end of period				
Unpaid Obligations	$ 11,584	$ 12,941	$ 9,225	$ 10,763
Less: Uncollected customer payments from Federal Sources		30		34
Total, unpaid obligated balance, net, end of period	**$ 11,584**	**$ 12,911**	**$ 9,225**	**$ 10,729**
Net Outlays				
Net Outlays:				
Gross Outlays	$ 50,010	$ 54,460	$ 32,092	$ 46,364
Less: Offsetting collections	1,967	77,367	3,072	49,510
Less: Distributed Offsetting receipts	51		32	
Net Outlays (Note 12)	**$ 47,992**	**$ (22,907)**	**$ 28,988**	**$ (3,146)**

The accompanying notes are an integral part of these statements

United States Department of Education
Federal Student Aid
Consolidated Statement of Financing
For the Years Ended September 30, 2006 and 2005
(Dollars in Millions)

		Fiscal Year 2006		Fiscal Year 2005
Resources Used to Finance Activities				
Budgetary Resources Obligated				
Obligations Incurred (Note 12)	$	(113,462)	$	(83,860)
Less: Spending Authority from Offsetting Collections & Recoveries		83,785		55,612
Obligations Net of Offsetting Collections and Recoveries		(29,677)		(28,248)
Less: Offsetting Receipts		(51)		(32)
Net Obligations	$	(29,728)	$	(28,280)
Other Resources				
Imputed Financing From Costs Absorbed by Others		(8)		(9)
Net Other Resources Used to Finance Activities		(8)		(9)
Total Resources Used to Finance Activities	**$**	**(29,736)**	**$**	**(28,289)**
Resources Used to Finance Items Not Part of Net Cost of Operations				
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not Yet Provided (+/-)	$	(3,565)	$	(2,608)
Resources that Fund Expenses Recognized in Prior Period (Note 13)		(2,801)		(1,573)
Budgetary offsetting collections and receipts that do not affect net cost of operations				2
Credit Program Collections Which Increase/Decrease Liabilities for Loan Guarantees, or Credit Program Receivables, Net including Allowances for Subsidy		73,678		46,853
Resources Used to Finance the Acquisition of Fixed Assets, or Increase/Decrease Liabilities for Loan Guarantees or Credit Program Receivables, Net in the Current or Prior Period		(48,272)		(39,951)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	**$**	**19,040**	**$**	**2,723**
Total Resources Used to Finance the Net Cost of Operations	**$**	**(48,776)**	**$**	**(31,012)**
Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period				
Components Requiring or Generating Resources in Future Periods (Note 13)				
Increase in Annual Leave Liability	$	(8)	$	(7)
Upward/Downward Reestimates of Credit Subsidy Expense		(4,200)		(2,789)
Increase in Exchange Revenue Receivable from the Public		1,603		1,163
Other (+/-)		43		34
Total Components of the Net Cost of Operations that Will Require or Generate Resources in Future Periods	$	(2,562)	$	(1,599)
Components Not Requiring or Generating Resources				
Depreciation and Amortization	$	401	$	1,446
Other (+/-) (Note 13)		(94)		3
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources	$	307	$	1,449
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period	**$**	**(2,255)**	**$**	**(150)**
Net Cost of Operations (Note 10)	**$**	**(51,031)**	**$**	**(31,162)**

The accompanying notes are an integral part of these statements

NOTES TO PRINCIPAL FINANCIAL STATEMENTS
FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Note 1. Summary of Significant Accounting Policies

Reporting Entity

Federal Student Aid (FSA) was created as a Performance Based Organization (PBO) within the U.S. Department of Education (the Department) under the *Higher Education Act of 1965*, as amended (HEA), from previously existing Department student financial assistance programs. FSA operates under the PBO mandate to develop a management structure driven by strong incentives to manage for results. FSA's primary goal is to assist lower-income and middle-income students in overcoming the financial barriers that make it difficult to attend and complete postsecondary education. It is responsible for administering direct loans, guaranteed loans, and grant programs.

The William D. Ford Federal Direct Student Loan (Direct Loan) Program, authorized by the *Student Loan Reform Act of 1993*, enables FSA to make loans directly to eligible undergraduate and graduate students and their parents through participating schools. FSA borrows money from Treasury to fund the loans. The program provides interest subsidies for eligible borrowers.

The Federal Family Education Loan (FFEL) Program, authorized by the HEA, cooperates with state and private nonprofit Guaranty Agencies to provide loan guarantees and interest subsidies on loans made by private lenders to eligible students.

Under the Direct Loan and FFEL programs, the loans are made to individuals who meet statutorily set eligibility criteria and attend eligible institutions of higher education—public or private two- and four-year institutions, graduate schools, and vocational training schools. Students and their parents, based on eligibility criteria, receive loans regardless of income or credit rating. Student borrowers who demonstrate financial need also receive federal interest subsidies.

The grant programs, consisting of the Federal Pell Grant (Pell Grant) Program and campus-based student aid program, enable FSA to provide educational grants and other financial assistance to eligible applicants, which are not repaid to the federal government. The Pell Grant Program provides grant aid to low-income and middle-income undergraduate students. Awards vary in proportion to the financial circumstances of students and their families. The campus-based student aid programs provide educational grants and other financial assistance to eligible applicants. These programs include the Supplemental Educational Opportunity Grant, Work-Study, and Perkins Loan. Campus-based programs are not material to these statements and have been included with other programs reported under grant programs.

Basis of Accounting and Presentation

These consolidated financial statements have been prepared to report the financial position, net cost of operations, changes in net position, budgetary resources, and financing of the Federal Student Aid reporting group, as required by the *Chief Financial Officers Act of 1990* and the *Government Management Reform Act of 1994*. The financial statements were prepared from the books and records of FSA, in accordance with accounting principles generally accepted in the United States of America for federal entities issued by the Federal Accounting Standards

Advisory Board (FASAB) and the Office of Management and Budget (OMB) Circular No. A-136, revised as of July 24, 2006, *Financial Reporting Requirements*. These financial statements are different from the financial reports prepared by the Department pursuant to the OMB directives that are used to monitor and control FSA's use of budgetary resources.

FSA's financial statements should be read with the realization they represent the reporting group, FSA, within the Department of Education, which is itself a component of the U.S. Government, a sovereign entity. One implication of this is that the liabilities cannot be liquidated without legislation providing resources and legal authority to do so.

The accounting structure of federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned, and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds.

Use of Estimates

The preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make assumptions and estimates that directly affect the amounts reported in the financial statements. Actual results may differ from those estimates.

The *Federal Credit Reform Act of 1990* (Credit Reform Act) underlies the proprietary and budgetary accounting treatment of direct and guaranteed loans. The long-term cost to the government for direct loans or loan guarantees, other than for general administration of the programs, is referred to as "subsidy cost". Under the Credit Reform Act, subsidy costs for loans obligated beginning in fiscal year (FY) 1992 are estimated at the net present value of projected lifetime costs in the year the loan is obligated. Subsidy costs are then revalued annually through the re-estimate process.

Estimates for credit program receivables and liabilities contain assumptions that have a significant impact on the financial statements. The primary components of this assumption set include, but are not limited to, collections (including loan consolidations), repayments, default rates, prevailing interest rates and loan volume. Actual loan volume, interest rates, cash flows and other critical components used in the estimation process may differ significantly from the assumptions made at the time the financial statements were prepared. Minor adjustments to any of these components may create significant changes to the estimate.

FSA and the Department estimate all future cash flows associated with the Direct Loan and FFEL programs. Projected cash flows are used to develop subsidy estimates. Subsidy cost can be positive or negative; negative subsidies occur when expected program inflows of cash (e.g., repayments and fees) exceed expected outflows. Subsidy cost is recorded as the initial amount of the loan guarantee liability when guarantees are made (the loan liability) and as a valuation allowance to government-owned loans and interest receivable (i.e., direct and defaulted guaranteed loans).

FSA and the Department use a computerized cash flow projection Student Loan Model to calculate subsidy estimates for the Direct Loan and FFEL programs. In fiscal year 2006, the Department refined its approach to calculating the subsidy estimates with the input of interest rates derived from a probabilistic technique. This probabilistic technique to forecast interest rates relies on different methods to establish the relationship between an event's occurrence and the magnitude of its probability. The Department's approach estimates interest rates under numerous scenarios and then bases interest rates on the average interest rates weighted by the assumed probability of each scenario occurring. This refinement was undertaken to model certain unique characteristics of the Department's loan programs.

The estimating methods are updated periodically to reflect changing conditions. For each program, cash flows are projected over the life of the loan, aggregated by loan type, cohort year, and risk category. The loan's cohort year represents the year a direct loan was obligated or a loan was guaranteed, regardless of the timing of disbursements. Risk categories include two-year colleges, freshmen and sophomores at four-year colleges, juniors and seniors at four-year colleges, graduate schools, and proprietary (for profit) schools.

Estimates reflected in these statements were prepared using assumptions developed for the FY 2007 Mid-Session Review, a government-wide exercise required annually by the OMB. Assumptions and their impact are updated after the Mid-Session Review to account for significant subsequent changes in activity. These estimates are based on the most current information available to FSA and the Department at the time the financial statements are prepared. FSA and the Department management have a process to review these estimates in the context of subsequent changes in activity and assumptions, and to reflect the impact of these changes as appropriate.

FSA and the Department recognize that the cash flow projections and the sensitivity of the changes in assumptions can have a significant impact on the estimates. Management has attempted to mitigate fluctuations in the estimate by using trend analysis to project future cash flows. Changes in assumptions could significantly affect the amounts reflected in these statements. For example, a minimal change in the projected long-term interest rate charged to borrowers could change the current subsidy re-estimate by a significant amount. (See Note 5)

Budget Authority

Budget authority is the authorization provided by law for the Department and FSA to incur financial obligations that will result in outlays. FSA's budgetary resources include (1) unobligated balances of resources from prior years, (2) recoveries of obligations in prior years, and (3) new resources—appropriations, authority to borrow from the U.S. Department of Treasury (Treasury), and spending authority from collections.

Authority to borrow from Treasury provides most of the funding for the loan principal disbursements made under the Direct Loan Program. Subsidy and administrative costs of the program are funded by appropriations. Budgetary resources from collections are used primarily to repay FSA's debt to Treasury. Major sources of collections include (1) principal and interest collections from borrowers or through the consolidation of loans to borrowers, (2) related fees, and (3) interest from Treasury on balances in certain credit program accounts that make and administer loans and guarantees.

Fund Balance with Treasury

The Fund Balance with Treasury includes appropriated and revolving funds available to pay current liabilities and finance authorized purchases, as well as funds restricted until future appropriations are received. Treasury processes the cash receipts and cash disbursements for FSA. FSA's records are reconciled with those of Treasury.

Revolving funds conduct continuing cycles of business-like activity and do not require annual appropriations. Their fund balance is derived from borrowings, public collections and other federal agencies. Other funds, which are non-budgetary, primarily consist of deposit funds.

Available unobligated balances represent amounts that are apportioned for obligation in the current fiscal year. Unavailable unobligated balances represent amounts that are not apportioned for obligation during the current fiscal year and expired appropriations no longer available to incur new obligations. Obligated balances not yet disbursed include receivables for reimbursements earned, unfilled customer orders, undelivered orders and unpaid expended authority. (See Note 2)

Accounts Receivable

Accounts receivable are amounts due to FSA from the public and other federal agencies. Receivables from the public result from recipients of grants and other financial assistance programs, and disputed costs resulting from audits of educational assistance programs. Amounts due from other federal agencies result from reimbursable agreements entered into by FSA with these agencies for various goods and services. Accounts receivable are recorded at cost less an allowance for uncollectible amounts. Estimates for the allowance for loss on uncollectible accounts are based on historical data. (See Note 3)

Cash and Other Monetary Assets

Cash and Other Monetary Assets consist of Guaranty Agency reserves that represent the federal government's interest in the net assets of state and nonprofit FFEL Program Guaranty Agencies. Guaranty Agency reserves are classified as non-entity assets with the public (see Note 4) and are offset by a corresponding liability due to Treasury. Guaranty Agency reserves include initial federal start-up funds, receipts of federal reinsurance payments, insurance premiums, Guaranty Agency share of collections on defaulted loans, investment income, administrative cost allowances, and other assets.

Section 422A of the HEA required FFEL Guaranty Agencies to establish a Federal Student Loan Reserve Fund (the "Federal Fund") and an Operating Fund by December 6, 1998. The Federal Fund and the non-liquid assets developed or purchased by a Guaranty Agency as a result, in whole or in part with federal funds, are the property of the United States and reflected in the *Budget of the United States Government*. However, such ownership by the federal government is independent of the actual control of the assets. The net value of the Federal Fund will change from year to year. Recalls are payments to the Department from Guaranty Agency Federal Funds, which increase Fund Balance with Treasury, and will be remitted to Treasury by the end of the fiscal year.

FSA disburses funds to the Guaranty Agency through the Federal Fund to pay lender claims and default aversion fees of a Guaranty Agency. The Operating Fund is the property of the Guaranty Agency except for funds an agency borrows from the Federal Fund (as authorized under Section 422A of the HEA). The Operating Fund is used by the Guaranty Agency to fulfill its responsibilities. These responsibilities include repaying money borrowed from the Federal Fund, default aversion and collection activities.

Credit Program Receivables and Liabilities for Loan Guarantees

The financial statements reflect the Department's estimate of the long-term cost of direct and guaranteed loans in accordance with the Credit Reform Act. Loans and interest receivable are valued at their gross amounts less an allowance for the present value of the amounts not expected to be recovered and thus having to be subsidized—called "allowance for subsidy". The difference is the present value of the cash flows to and from FSA that are expected from the receivables over their projected lives. Similarly, liabilities for loan guarantees are valued at the present value of the cash outflows from FSA less the present value of related inflows. The estimated present value of net long-term cash outflows of FSA for subsidized costs (primarily defaults) is net of recoveries, interest supplements, and offsetting fees. FSA records all credit program loans and loan guarantees at their present values.

Components of subsidy costs for loans and guarantees include defaults (net of recoveries), contractual payments to third-party private loan collectors who receive a set percentage of amounts they collect, and, as an offset, application and other fees to be collected. For direct loans, the difference between interest rates incurred by the Department and FSA on its borrowings from Treasury and interest rates charged to target groups is also subsidized (or may provide an offset to subsidy if the Department's rate is less). The corresponding interest subsidy in loan guarantee programs is the payment of interest supplements to third-party lenders in order to buy down the interest rates on loans made by those lenders. Subsidy costs are recognized when direct loans or guaranteed loans are disbursed to borrowers and are re-estimated each year. (See Note 5)

General Property, Plant and Equipment

In accordance with the Department's policy, FSA capitalizes single items of property and equipment with a cost of $50,000 or more that have an estimated useful life greater than two years. Additionally, FSA capitalizes bulk purchases of property and equipment with an aggregate cost of $500,000 or more. A bulk purchase is defined as the purchase of like items related to a specific project or the purchase of like items occurring within the same fiscal year that have an estimated useful life greater than two years. Property and equipment are depreciated over their estimated useful lives using the straight-line method of depreciation. Internal Use Software (IUS) meeting the above cost and useful life criteria is also capitalized. IUS is either purchased off the shelf, internally developed, or contractor developed solely to meet the agency's internal needs.

The Department adopted the following useful lives for the major classes of depreciable property and equipment:

Major Classes of Depreciable Property and Equipment	Years
Information Technology (IT), Internal Use Software (IUS) and Telecommunications Equipment	3
Furniture and Fixtures	5

Liabilities

Liabilities represent actual and estimated amounts likely to be paid as a result of transactions or events that have already occurred. However, no liabilities can be paid by FSA or the Department without an appropriation or other collection of revenue for services provided. Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources, and there is no certainty the appropriation will be enacted. The government acting in its sovereign capacity can abrogate liabilities that arise from activities other than contracts. FFEL Program and Direct Loan Program liabilities are entitlements covered by permanent indefinite budget authority enacted as of year-end.

Debt

FSA and the Department borrow to provide funding for direct loans to students program. The liability to Treasury from borrowings represents unpaid principal owing on the loans at year-end associated with FSA's direct loan activities. FSA repays the loan principal based on available fund balances. Interest on the debt is calculated at fiscal year-end using rates set by Treasury, with such rates generally fixed based on the rate for 10-year securities. As discussed in Note 5, the interest received by FSA from borrowers will vary from the rate paid to the Treasury. Principal and interest payments to the Treasury are made annually. (See Note 6)

Accrued Grant Liability

Disbursements of grant funds are recognized as expenses at the time of disbursement. However, some grant recipients incur expenditures prior to initiating a request for disbursement based on the nature of the expenditures. A liability is accrued by FSA for expenditures incurred by grantees prior to their receiving grant funds for the expenditures. The amount is estimated using statistical sampling techniques. (See Note 8)

Net Position

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include undelivered orders and unobligated balances of appropriations, except for federal credit financing and liquidating funds. Cumulative results of operations represent the net difference since inception between (1) expenses and (2) revenues and financing sources. (See Note 9)

Personnel Compensation and Other Employee Benefits

Annual, Sick and Other Leave. The liability for annual leave, compensatory time off, and other leave is accrued when earned and reduced when taken. Each year, the accrued annual leave account balance is adjusted to reflect current pay rates. Annual leave earned but not taken, within established limits, is funded from future financing sources. Sick leave and other types of non-vested leave are expensed as taken**.**

Retirement Plans and Other Retirement Benefits. Employees participate either in the Civil Service Retirement System (CSRS), a defined benefit plan, or in the Federal Employees Retirement System (FERS), a defined benefit and contribution plan. For CSRS employees, the Department contributes a fixed percentage of pay.

FERS consists of Social Security, a basic annuity plan, and the Thrift Savings Plan. The Department and the employee contribute to Social Security and the basic annuity plan at rates prescribed by law. In addition, the Department is required to contribute to the Thrift Savings Plan a minimum of 1 percent per year of the basic pay of employees covered by this system and to match voluntary employee contributions up to 3 percent of the employee's basic pay, and one-half of contributions between 3 percent and 5 percent of basic pay. For FERS employees, the Department also contributes the employer's share of Medicare.

Contributions for CSRS, FERS and other retirement benefits are insufficient to fully fund the programs, which are subsidized by the Office of Personnel Management (OPM). The Department imputes its share of the OPM subsidy, using cost factors OPM provides, and reports the full cost of the programs related to its employees.

Federal Employees' Compensation Act. The *Federal Employees' Compensation Act* (FECA) provides income and medical cost protection to covered federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. The FECA Program is administered by the U.S. Department of Labor (Labor), which pays valid claims and subsequently seeks reimbursement from the Department for these paid claims.

The FECA liability consists of two components. The first component is based on actual claims paid by Labor but not yet reimbursed by the Department. The Department reimburses Labor for the amount of actual claims as funds are appropriated for this purpose. There is generally a two- to three-year time period between payment by Labor and reimbursement by the Department. As a result, a liability is recognized for the actual claims paid by Labor and to be reimbursed by the Department.

The second component is the estimated liability for future benefit payments as a result of past events. This liability includes death, disability, medical and miscellaneous costs. Labor determines this component annually, as of September 30, using a method that considers historical benefit payment patterns, wage inflation factors, medical inflation factors, and other variables. The projected annual benefit payments are discounted to present value using the OMB economic assumptions for 10-year Treasury notes and bonds. To provide for the effects of inflation on the liability, wage inflation factors (i.e., cost-of-living adjustments), and medical inflation factors (i.e., consumer price index medical adjustments) are applied to the calculation of projected future benefit payments. These factors are also used to adjust historical benefit payments and to adjust future benefit payments to current year constant dollars. A discounting formula is also used to recognize the timing of benefit payments as 13 payments per year instead of one lump sum payment per year.

The estimated projections are evaluated by Labor to ensure the resulting projections are reliable. The analysis is based on four tests: (1) a sensitivity analysis of the model to economic assumptions, (2) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual incremental payments, (3) a comparison of the incremental paid losses per case (a measure of case-severity) in charge back year 2006 to the average pattern observed during the most current three charge back years, and (4) a comparison of the estimated liability per case in the 2006 projection to the average pattern for the projections of the most recent three years.

A portion of the estimated liability for disability benefits assigned to the Department under the FECA Program is accrued by FSA. The accrual is based on the present value of estimated net future payments by the Department of Labor.

Intragovernmental Transactions

FSA's financial activities interact with and are dependent upon the financial activity of the centralized management functions of the federal government. Due to financial regulation and management control by the OMB and Treasury, operations may not be conducted and financial positions may not be reported as they would if FSA were a separate, unrelated entity.

Reclassifications

Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

Note 2. Fund Balance with Treasury

(Dollars in Millions)	2006	2005
Appropriated Funds	$ 15,393	$ 9,764
Revolving Funds	52,175	28,104
Other Funds	8	8
Fund Balance with Treasury	**$ 67,576**	**$ 37,876**

Status of Fund Balance with Treasury

(Dollars in Millions)	2006	2005
Unobligated Balance		
Available	$ 3,437	$ 31
Unavailable	46,874	23,327
Obligated Balance, Not Yet Disbursed	17,257	14,510
Non-Budgetary FBWT	8	8
Status of Fund Balance with Treasury	**$ 67,576**	**$ 37,876**

Note 3. Accounts Receivable

	2006		
(Dollars in Millions)	Gross Receivables	Allowance	Net Receivables
Intragovernmental	$ -	$ -	$ -
With the Public	50	(19)	31
Accounts Receivable	**$ 50**	**$ (19)**	**$ 31**

	2005		
(Dollars in Millions)	Gross Receivables	Allowance	Net Receivables
Intragovernmental	$ -	$ -	$ -
With the Public	153	(22)	131
Accounts Receivable	**$ 153**	**$ (22)**	**$ 131**

Note 4. Cash and Other Monetary Assets

(Dollars in Millions)	2006	2005
Beginning Balance, Cash and Other Monetary Assets	**$ 888**	**$ 1,040**
Downward Valuation of Guaranty Agency Federal Funds	(29)	(152)
Recalls from Guaranty Agency Federal Funds		
Remitted to Treasury as of September 30	(280)	-
Payable to Treasury as of September 30	(13)	-
Total Recalls	(293)	-
Ending Balance, Cash and Other Monetary Assets	**$ 566**	**$ 888**

Cash and Other Monetary Assets consist of Guaranty Agency reserves and represent non-entity assets.

Note 5. Credit Programs for Higher Education

The federal government makes loans directly to students and parents through participating schools under the Direct Loan Program. In addition, loans are originated and serviced through contracts with private vendors.

Private lender loans to students and parents are insured by the federal government under the FFEL Program. FFEL loans are guaranteed by the federal government against default, with state or private nonprofit Guaranty Agencies acting as intermediaries in administering the guarantees.

Beginning with FFEL loans first disbursed on or after October 1, 1993, financial institutions became responsible for 2 percent of the cost of each default. Guaranty Agencies also began paying a portion of the cost (in most cases, 5 percent) of each defaulted loan from federal reserves they hold in trust. (See Note 4) FFEL lender participants receive statutorily set federal interest and special allowance subsidies. Guaranty Agencies receive fee payments as set by statute. In most cases, loan terms and conditions under the two programs are identical.

The FFEL estimated liability for loan guarantees is reported as the present value of estimated net cash outflows. Defaulted FFEL loans are reported net of an allowance for subsidy computed using net present value methodology, including defaults, collections, and loan cancellations. The same methodology is used to estimate the allowance on Direct Loan receivables.

The Department disbursed approximately $32.3 billion in direct loans to eligible borrowers in fiscal year 2006 and approximately $27.5 billion in fiscal year 2005. Loans typically are disbursed in multiple installments over an academic period; as a result, loan disbursements for an origination cohort year often cross fiscal years. Half of all loan volume is obligated in the fourth quarter of the fiscal year. Regardless of the fiscal year in which they occur, disbursements are tracked by cohort as determined by the date of obligation rather than disbursement.

As of September 30, 2006 and 2005, total principal balances outstanding of guaranteed loans held by lenders were approximately $325 billion and $289 billion, respectively. As of September 30, 2006 and 2005, the estimated maximum government exposure on outstanding guaranteed loans held by lenders was approximately $321 billion and $288 billion, respectively. Of the insured amount, the Department would pay a smaller amount to the Guaranty Agencies, based on the appropriate reinsurance rates, which range from 100 to 95 percent. Any remaining insurance not paid as reinsurance would be paid to lenders by the Guaranty Agencies from their Federal Funds. Payments by Guaranty Agencies do not reduce government exposure because they are made from the Federal Fund administered by the agencies but owned by the federal government.

The Department accrues interest receivable and records interest revenue on its performing direct loans. Given the Department's substantial collection rates, interest receivable is also accrued and interest revenue recognized on defaulted direct loans. Guaranteed loans that default are initially turned over to Guaranty Agencies for collection, and interest receivable is accrued and recorded on the loans as the collection rate is substantial. After approximately four years, defaulted guaranteed loans not in repayment are turned over to the Department for collection. Accrued interest on the subrogated loan is calculated but only realized upon collection.

Due to the nature of the loan commitment process in which schools establish a loan commitment with the filing of an aid application, which may occur before a student has been accepted by the school or begins classes, approximately 7 percent of loan commitments are never disbursed. For direct loans committed in fiscal year 2006, an estimated $1.2 billion will not be disbursed; for guaranteed loans committed in fiscal year 2006, an estimated $7.6 billion will not be disbursed. Direct loan schools may originate loans through a cash advance from the Department, establishing a loan receivable, or by advancing their own funds in anticipation of reimbursement from the Department.

Loan Consolidations

In recent years, the consolidation of existing loans into new direct or guaranteed loans has increased significantly. The Department permits borrowers to prepay and close out existing loans without penalty from capital raised through the disbursement of a new consolidation loan.

Under the Credit Reform Act and requirements provided by OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, the retirement of loans being consolidated is considered a receipt of principal and interest; this receipt is offset by the disbursement related to the newly created consolidation loan. The underlying direct or guaranteed loans, whether performing or nonperforming, in any given cohort are paid off in their original cohort, and new loans are opened in the cohort in which consolidation activity occurs. This consolidation activity is taken into consideration in establishing the subsidy rate for defaults. The effect of new consolidations is reflected in subsidy expense for the current year cohort, while the effect on prior cohorts is reflected in the re-estimate. The loan liability and net receivables include estimates of future prepayments of existing loans through consolidations; they do not reflect costs associated with anticipated future consolidation loans.

Variable student loan interest rates were reset on July 1, 2006, increasing nearly two percentage points from 5.30 percent for academic year 2005–06 to 7.14 percent for academic year 2006–07. In fiscal year 2005, rates were reset on July 1, 2005, from 3.37 percent for academic year 2004–05 to 5.30 percent for academic year 2005–06. In anticipation of these increases in both years, private lenders, schools, and others encouraged borrowers to consolidate their existing variable rate loans into fixed rate loans. This dramatic change in interest rates resulted in surges in loan consolidations. Direct loan consolidation disbursements for fiscal year 2006 were $19.9 billion and $15.3 billion for fiscal year 2005.

Based on current estimates, the prepayment of the underlying FFEL loans produces significant savings through the elimination of future special allowance payments. New consolidations are reflected in the 2006 cohort resulting in increased prepayments of underlying loans from prior cohorts.

Credit Program Receivables, Net

(Dollars in Millions)	2006	2005
Direct Loan Program Loan Receivables, Net	$ 92,603	$ 95,696
FFEL Program Loan Receivables, Net	13,588	11,712
Perkins Program Loan Receivables, Net	192	194
Credit Program Receivables, Net	**$ 106,383**	**$ 107,602**

The following schedules summarize the Direct Loan and defaulted FFEL principal and related interest receivable, net or inclusive of the allowance for subsidy.

Direct Loan Program Receivables

(Dollars in Millions)	2006	2005
Principal Receivable	$ 97,306	$ 94,707
Interest Receivable	3,702	3,121
Receivables	**101,008**	**97,828**
Less: Allowance for Subsidy	8,405	2,132
Credit Program Receivables, Net	**$ 92,603**	**$ 95,696**

Of the $101.0 billion in Direct Loan receivables as of September 30, 2006, $8.1 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group. As of September 30, 2005, $7.2 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group out of a total receivable of $97.8 billion.

FFEL Program Receivables

	2006			2005		
(Dollars in Millions)	Pre-1992	Post-1991	Total	Pre-1992	Post-1991	Total
Principal Receivable	$ 8,730	$ 10,263	$ 18,993	$ 9,306	$ 8,567	$ 17,873
Interest Receivable	336	1,823	2,159	595	1,691	2,286
Receivables	**9,066**	**12,086**	**21,152**	**9,901**	**10,258**	**20,159**
Less: Allowance for Subsidy	4,717	2,847	7,564	6,736	1,711	8,447
Credit Program Receivables, Net	**$ 4,349**	**$ 9,239**	**$ 13,588**	**$ 3,165**	**$ 8,547**	**$ 11,712**

Loan Modifications

According to OMB Circular No. A-11, any government action that differs from actions assumed in the baseline estimate of cash flows and changes the estimated cost of an outstanding direct loan or loan guarantee is defined as a modification. Over the past two fiscal years, the Department has executed separate loan modifications. These modifications were the result of legislation that altered the estimated cost of outstanding direct loans or loan guarantees. Each modification is separate and distinct. However, each is recognized under the same accounting principle for upward or downward adjustments to subsidy cost and for the recordation of modification adjustment transfer gains or losses.

Separate amounts are calculated for modification costs and modification adjustment transfers. Modification adjustment transfers are required to adjust for the difference between current discount rates used to calculate modification costs and the discount rates used to calculate cohort interest expense and revenue.

2006 Modification

The *Deficit Reduction Act of 2005* (P.L. 109-171) (Deficit Reduction Act) included provisions revising the payment of account maintenance fees, Guaranty Agency retention on default collections, and an expansion of deferment eligibility for military borrowers performing eligible service. The Deficit Reduction Act shifts the payment of account maintenance fees, authorized under Section 458 of the HEA, to subsidy cost from administration funds or from the Federal Fund.

Beginning October 1, 2006, the Deficit Reduction Act requires Guaranty Agencies to return to the Department a portion of collection charges on defaulted loans paid off through consolidation equal to 8.5 percent of the outstanding principal and interest. Beginning October 1, 2009, Guaranty Agencies will be required to return the entire 18.5 percent on collections through consolidation that exceed 45 percent of their overall collections. In addition, the new military deferment provisions provide a maximum three-year deferment for soldiers serving in a war zone who have outstanding loans originated after July 1, 2001.

The FFEL Program recognized $1.7 billion and the Direct Loan Program recognized $7 million in modification costs in fiscal year 2006. The FFEL Program also recognized a net modification adjustment transfer gain of $94 million, while the Direct Loan Program recognized a net gain of $134 thousand.

2005 Modification

The *Taxpayer-Teacher Protection Act of 2004* (P.L. 108-409) increased the maximum amount of loan cancellation from $5,000 to $17,500 at the end of the fifth year of teaching for certain teachers who were new student loan borrowers between October 1, 1998 and October 1, 2005.

The FFEL Program recognized $148 million and the Direct Loan Program recognized $49 million in modification costs in fiscal year 2005. The FFEL Program also recognized a net modification adjustment transfer gain of $3 million, while the Direct Loan Program recognized a net gain of $1 million.

Direct Loan Program Reconciliation of Allowance for Subsidy

(Dollars in Millions)	2006	2005
Beginning Balance, Allowance for Subsidy	**$ 2,132**	**$ (1,644)**
Components of Subsidy Transfers		
Interest Rate Differential	(601)	(238)
Defaults, Net of Recoveries	1,226	355
Fees	(403)	(401)
Other	1,566	1,286
Current Year Subsidy Transfers	**1,788**	**1,002**
Components of Subsidy Re-estimates		
Interest Rate Re-estimates[1]	(339)	1,703
Technical and Default Re-estimates	5,199	2,457
Subsidy Re-estimates	**4,860**	**4,160**
Components of Loan Modifications		
Loan Modification Costs	7	49
Modification Adjustment Transfers	-	(1)
Loan Modifications	**7**	**48**
Activity		
Fee Collections	473	461
Loan Cancellations[2]	(100)	(110)
Subsidy Allowance Amortization	(406)	(1,454)
Other	(349)	(331)
Total Activity	**(382)**	**(1,434)**
Ending Balance, Allowance for Subsidy	**$ 8,405**	**$ 2,132**

[1] The interest rate re-estimate relates to subsidy associated with establishing a fixed rate for the Department's borrowing from Treasury.
[2] Loan cancellations include write-offs of loans because the primary borrower died, became disabled, or declared bankruptcy.

Direct Loan Financing Account Interest Expense and Interest Revenue

(Dollars in Millions)	2006	2005
Interest Expense on Treasury Borrowing	$ 6,505	$ 6,171
Interest Expense	**$ 6,505**	**$ 6,171**
Interest Revenue from the Public	$ 4,173	$ 3,242
Amortization of Subsidy	406	1,454
Interest Revenue on Uninvested Funds	1,926	1,475
Interest Revenue	**$ 6,505**	**$ 6,171**

The Direct Loan Financing Account borrows from Treasury to fund the unsubsidized portion of its lending activities. As required, the Department calculates and pays Treasury interest at the end of each year. Interest is earned on the outstanding Direct Loan portfolio during the year and on its weighted average Fund Balance with Treasury at year-end.

Subsidy amortization is calculated, as required in Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees*, as the difference between interest revenue and interest expense. The allowance for subsidy is adjusted with the offset to interest revenue.

Payable to Treasury

(Dollars in Millions)	2006	2005
Future Liquidating Account Collections, Beginning Balance	$ 3,411	$ 3,491
Valuation of Pre-1992 Loan Liability and Allowance	2,036	851
Capital Transfers to Treasury	(892)	(931)
Future Liquidating Account Collections, Ending Balance	**4,555**	**3,411**
Collections on Guaranty Agency Federal Funds	13	-
FFEL Downward Subsidy Re-estimate	951	1,755
Payable to Treasury	**$ 5,519**	**$ 5,166**

The liquidating account, based on available fund balance each year, liquidates the Fund Balance with Treasury. The FFEL financing account pays the liability related to downward subsidy re-estimates upon budget execution.

FFEL Program Reconciliation of Liabilities for Loan Guarantees

(Dollars in Millions)	2006	2005
Beginning Balance, Liability for Loan Guarantees	**$ 30,500**	**$ 23,214**
Components of Subsidy Transfers		
Interest Supplement Costs	18,268	12,562
Defaults, Net of Recoveries	1,665	865
Fees	(7,859)	(5,554)
Other[1]	4,264	2,500
Current Year Subsidy Transfers	**16,338**	**10,373**
Components of Subsidy Re-estimates		
Interest Rate Re-estimates	90	(72)
Technical and Default Re-estimates	9,924	(586)
Subsidy Re-estimates	**10,014**	**(658)**
Components of Loan Modifications		
Loan Modification Costs	1,710	148
Modification Adjustment Transfers	94	(3)
Loan Modifications	**1,804**	**145**
Activity		
Interest Supplement Payments	(8,925)	(5,077)
Claim Payments	(4,345)	(3,716)
Fee Collections	3,799	3,060
Interest on Liability Balance	1,110	565
Other[2]	2,055	2,594
Total Activity	**(6,306)**	**(2,574)**
Ending Balance, Liability for Loan Guarantees	**52,350**	**30,500**
FFEL Liquidating Account Liability for Loan Guarantees	103	111
Liabilities for Loan Guarantees	**$ 52,453**	**$ 30,611**

[1] Subsidy primarily associated with debt collections and loan cancellations due to death, disability, and bankruptcy.
[2] Activity primarily associated with the transfer of subsidy for defaults; loan consolidation activity; and loan cancellations due to death, disability, and bankruptcy.

The FFEL liquidating account liability for loan guarantees is included in the total Liabilities for Loan Guarantees as shown in the FFEL Program Reconciliation of Liabilities.

Subsidy Expense

Direct Loan Program Subsidy Expense

(Dollars in Millions)	2006	2005
Components of Current Year Subsidy Transfers		
Interest Rate Differential	$ (601)	$ (238)
Defaults, Net of Recoveries	1,226	355
Fees	(403)	(401)
Other	1,566	1,286
Current Year Subsidy Transfers	**1,788**	**1,002**
Subsidy Re-estimates	4,860	4,160
Loan Modification Costs	7	49
Direct Loan Subsidy Expense	**$ 6,655**	**$ 5,211**

In the 2006 re-estimates, Direct Loan subsidy expense was increased by $4.9 billion. Several factors accounted for this increase. Changes in the assumptions for the collections of defaulted loans contributed approximately $3.3 billion to the increase in subsidy expense. Other changes in assumptions for variables (such as assumed term and maturity, loan volume, and prepayment rates) increased subsidy expense by $1.4 billion. A refinement of the Department's forecast using interest rate scenarios provided by OMB in a probabilistic approach accounted for an increase of $230 million. The subsidy rate is sensitive to interest rate fluctuations, for example a 1 percent increase in projected borrower base rates would reduce projected Direct Loan costs by $700 million. In the 2005 re-estimates, Direct Loan subsidy expense was increased by $4.2 billion. Changes in assumptions for variables (such as assumed term and maturity, loan volume and prepayment rates) increased subsidy expense by $4.0 billion. The remaining $195 million increase was related to changes in actual and forecasted interest rates.

FFEL Program Loan Guarantee Subsidy Expense

(Dollars in Millions)	2006	2005
Components of Current Year Subsidy Transfers		
Interest Supplement Costs	$ 18,268	$ 12,562
Defaults, Net of Recoveries	1,665	865
Fees	(7,859)	(5,554)
Other	4,264	2,500
Current Year Subsidy Transfers	**16,338**	**10,373**
Subsidy Re-estimates	10,014	(658)
Loan Modification Costs	1,710	148
FFEL Loan Guarantee Subsidy Expense	**$ 28,062**	**$ 9,863**

In the 2006 re-estimates, FFEL subsidy expense was increased by $10.0 billion. Changes in interest rates account for an $8.9 billion increase in subsidy expense. Of this $8.9 billion increase, $6.2 billion is attributed to the change in interest supplement costs associated with higher than originally forecasted loan consolidations, which occurred in late fiscal year 2006. In addition, the refinement of the Department's forecasting methodology, as noted above, accounted for an additional $1.8 billion to the increase in subsidy expense. Other changes in assumptions for variables (such as assumed term and maturity, loan volume, and prepayment rates) decreased subsidy expense by $700 million on a net basis. The subsidy rate is sensitive to interest rate fluctuations, for example a 1 percent increase in borrower interest rates and the guaranteed yield for lenders would increase projected FFEL costs by $9.5 billion. In the 2005 re-estimates, FFEL subsidy expense was decreased by $658 million. An increase of $932 million was caused by changes in actual and forecasted interest rates. Changes in assumptions for variables (such as assumed term and maturity, loan volume and prepayment rates) decreased subsidy expense by $1.6 billion.

Subsidy Rates

Subsidy Rates – Cohort 2006

	Interest Differential	Defaults	Fees	Other	Total
Direct Loan Program	(1.73%)	3.53%	(1.17%)	4.49%	5.12%
	Interest Supplements	**Defaults**	**Fees**	**Other**	**Total**
FFEL Program	14.44%	1.28%	(6.21%)	3.47%	12.98%

The subsidy rate represents the subsidy expense of the program in relation to the obligations or commitments made during the fiscal year. The subsidy expense for new direct or guaranteed loans reported in the current year relate to disbursements of loans from both current and prior years' cohorts. Subsidy expense is recognized when direct loans are disbursed by the Department, or third-party lenders disburse guaranteed loans. These subsidy rates cannot be applied to direct or guaranteed loans disbursed during the current reporting year to yield the subsidy expense, nor are these rates applicable to the portfolio as a whole.

The costs of the Department's student loan programs, especially the Direct Loan Program, are highly sensitive to changes in actual and forecasted interest rates. The formulas for determining program interest rates are established by statute; the existing loan portfolio has a mixture of borrower and lender rate formulas. Interest rate projections are based on probabilistic interest rate scenario inputs developed and provided by the President's Office of Management and Budget.

Administrative Expenses

	2006		2005	
(Dollars in Millions)	Direct Loan	FFEL	Direct Loan	FFEL
Operating Expense	$ 342	$ 224	$ 401	$ 268
Other Expense	15	8	17	8
Administrative Expenses	**$ 357**	**$ 232**	**$ 418**	**$ 276**

Perkins Loan Program

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In some statutorily defined cases, funds are provided to schools so that student loans may be cancelled. For certain defaulted loans, the Department reimburses the originating school and collects from the borrowers. These collections are transferred to the Treasury. At September 30, 2006 and 2005, loans receivable, net of an allowance for loss, were $192 and $194 million, respectively. These loans are valued at historical cost.

Note 6. Debt

(Dollars in Millions)	2006	2005
Beginning Balance, Debt	$ 104,372	$ 96,421
Accrued Interest	-	(2)
New Borrowing	33,278	31,299
Repayments	(32,220)	(23,346)
Ending Balance, Debt	**$ 105,430**	**$ 104,372**

The level of repayments on borrowings to Treasury is derived from many factors:

- Beginning-of-the-year cash balance, collections and borrowings have an impact on the available cash to repay Treasury.
- Cash is held to cover future liabilities, such as contract collection costs and disbursements in transit.

Note 7. Other Liabilities

(Dollars in Millions)	2006		2005	
Other Liabilities	**Intragovern-mental**	**With the Public**	**Intragovern-mental**	**With the Public**
Liabilities Covered by Budgetary Resources				
Current				
Employer Contributions and Payroll Taxes	$ 1	$ -	$ 1	$ -
Liability for Deposit Funds	-	8	-	8
Accrued Payroll and Benefits	-	4	-	4
Deferred Credits	-	1	-	1
Contractual Services	-	39	-	13
Total Other Liabilities Covered by Budgetary Resources	**1**	**52**	**1**	**26**
Liabilities Not Covered by Budgetary Resources				
Current				
Accrued Unfunded Annual Leave	-	7	-	7
Non-current				
Accrued Unfunded FECA Liability	1	-	1	-
Custodial Liability	-	192	-	194
Accrued FECA Actuarial Liability	-	4	-	4
Total Other Liabilities Not Covered by Budgetary Resources	**1**	**203**	**1**	**205**
Other Liabilities	**$ 2**	**$ 255**	**$ 2**	**$ 231**

Other liabilities include current and non-current liabilities. The non-current custodial liability consists of the student loan receivables of the Perkins Loan Program. Annually, at September 30, the collections are returned to the general fund of the U.S. Treasury.

Liabilities not covered by budgetary resources include liabilities for which congressional action is needed before budgetary resources can be provided. Although future appropriations to fund these liabilities are likely, it is not certain that appropriations will be enacted to fund these liabilities. Liabilities not covered by budgetary resources totaled $204 million and $206 million as of September 30, 2006 and 2005, respectively.

Liabilities covered by budgetary resources totaled $165.8 billion and $142.2 billion as of September 30, 2006 and 2005, respectively.

Note 8. Accrued Grant Liability

FSA's accrued grant liability was $1,250 million and $635 million as of September 30, 2006 and 2005, respectively. (See Note 1)

Note 9. Net Position

Unexpended Appropriations

(Dollars in Millions)	2006	2005
Unobligated Balances		
Available	$ 3,437	$ 31
Not Available	129	170
Undelivered Orders	10,073	8,396
Unexpended Appropriations	**$ 13,639**	**$ 8,597**

FSA had Cumulative Results of Operations of $(5,152) million as of September 30, 2006, and $(4,547) million as of September 30, 2005. Cumulative Results of Operations consist mostly of net investments of capitalized assets and unfunded expenses, including upward subsidy re-estimates for loan programs.

Note 10. Intragovernmental Cost and Exchange Revenue by Program Segment

As required by the *Government Performance and Results Act*, FSA's reporting organization has been aligned with a major goal presented in the U.S. Department of Education's *Strategic Plan 2002—2007*.

Strategic Goal 5, Enhance the Quality of and Access to Postsecondary and Adult Education, is a sharply defined directive that guides divisions to carry out the vision and programmatic mission of FSA. The net cost program relating to the strategic goal is the Enhancement of Postsecondary and Adult Education.

(Dollars in Millions)	2006	2005
Enhancement of Postsecondary and Adult Education		
Intragovernmental Gross Cost	$ 7,857	$ 7,055
Gross Costs with the Public	50,946	30,952
Total Program Costs	**58,803**	**38,007**
Less: Intragovernmental Earned Revenue	(3,131)	(2,140)
Earned Revenue from the Public	(4,641)	(4,705)
Total Program Revenue	**(7,772)**	**(6,845)**
Net Costs of Operations	**$ 51,031**	**$ 31,162**

Note 11. Interest Expense and Interest Revenue

(Dollars in Millions)	Direct Loan Program 2006	Direct Loan Program 2005	FFEL Program 2006	FFEL Program 2005	Total 2006	Total 2005
Federal	$ 6,505	$ 6,171	$ 1,110	$ 565	$ 7,615	$ 6,736
Non-federal	-	-	-	-	-	-
Interest Expense	**$ 6,505**	**$ 6,171**	**$ 1,110**	**$ 565**	**$ 7,615**	**$ 6,736**
Federal	$ 1,926	$ 1,475	$ 1,110	$ 565	$ 3,036	$ 2,040
Non-federal	4,579	4,696	-	-	4,579	4,696
Interest Revenue	**$ 6,505**	**$ 6,171**	**$ 1,110**	**$ 565**	**$ 7,615**	**$ 6,736**

For the Direct Loan Program, interest expense is recognized on the Department's borrowings from Treasury. The interest revenue is earned on the individual loans in the loan portfolio, while federal interest is earned on the uninvested Fund Balances with Treasury. For the FFEL Program, federal interest revenue is earned on the uninvested Fund Balance with Treasury in the financing fund.

Note 12. Statement of Budgetary Resources

The Statement of Budgetary Resources compares budgetary resources with the status of those resources. As of September 30, 2006, budgetary resources were $164,339 million and net outlays were $25,085 million. As of September 30, 2005, budgetary resources were $108,106 million and net outlays were $25,842 million.

Permanent Indefinite Budget Authority

The Direct Loan Program and the Federal Family Education Loan Program were granted permanent indefinite budget authority through legislation. Part D of the William D. Ford Federal Direct Loan Program and Part B of the Federal Family Education Loan Program, pursuant to the HEA, pertains to the existence, purpose, and availability of this permanent indefinite budget authority.

Reauthorization of Legislation

Funds for most Department programs are authorized, by statute, to be appropriated for a specified number of years, with an automatic one-year extension available under Section 422 of the *General Education Provisions Act*. Congress may continue to appropriate funds after the expiration of the statutory authorization period, effectively reauthorizing the program through the appropriations process. The current *Budget of the United States Government* presumes all programs continue per congressional budgeting rules.

Apportionment Categories of Obligations Incurred

(Dollars in Millions)	2006	2005
Direct and Reimbursable:		
Category A	$ 727	$ 736
Category B	112,559	82,872
Exempt from Apportionment	176	252
Apportionment Categories of Obligations Incurred	**$ 113,462**	**$ 83,860**

Category A apportionments are those resources that can be obligated without restriction on the purpose of the obligation, other than to be in compliance with legislation underlying programs for which the resources were made available. Category B apportionments are restricted by purpose for which obligations can be incurred. In addition, some resources are available without apportionment by the OMB.

Unused Borrowing Authority

(Dollars in Millions)	2006	2005
Beginning Balance, Unused Borrowing Authority	$ 5,442	$ 5,897
Current Year Borrowing Authority	35,073	32,170
Funds Drawn From Treasury	(33,278)	(31,299)
Prior Year Unused Borrowing Authority Cancelled	-	(1,326)
Ending Balance, Unused Borrowing Authority	**$ 7,237**	**$ 5,442**

FSA is given authority to draw funds from the Treasury to help finance the majority of its direct lending activity. Unused Borrowing Authority is a budgetary resource and is available to support obligations. FSA periodically reviews its borrowing authority balances in relation to its obligations and may cancel unused amounts.

Undelivered Orders at the End of the Period

	2006		2005	
(Dollars in Millions)	Budgetary	Non-Budgetary	Budgetary	Non-Budgetary
Undelivered Orders at the end of the period	**$ 10,121**	**$ 12,460**	**$ 8,413**	**$ 10,433**

Undelivered orders at the end of the year, as presented above, will differ from the undelivered orders included in the Net Position, Unexpended Appropriations. Undelivered orders for federal credit financing, liquidating funds and trust funds are not funded through appropriations and are not included in Net Position. (See Note 9)

Explanation of Differences Between the Statement of Budgetary Resources and the *Budget of the United States Government*

The *FY 2008 Budget of the United States Government* (President's Budget) presenting the actual amounts for the year ended September 30, 2006 has not been published as of the issue date of these financial statements. The FY 2008 President's Budget is scheduled for publication in February 2007. There were no material differences between the Fiscal Year 2005 column on the SBR to the actual amounts for FY 2005 in the FY 2007 President's Budget.

Note 13. Statement of Financing

The Statement of Financing (SOF) provides information on the total resources used by an agency, both those received through budgetary resources and those received through other means during the reporting period. The statement reconciles these resources with the net cost of operations by (1) removing resources that do not fund net cost of operations, and (2) including components of net cost of operations that did not generate or use resources during the year.

The SOF is presented as a consolidated statement for FSA and its major programs. Net interagency eliminations are presented for proprietary amounts. The budgetary amounts are reported on a combined basis as presented in the Statement of Budgetary Resources. Accordingly, net interagency eliminations for budgetary amounts are not presented.

The difference between the amounts reported as liabilities not covered by budgetary resources on the Balance Sheet and amounts reported as Other Components Requiring or Generating Resources in Future Periods on the Statement of Financing represents an increase in custodial liability activities.

Components Not Requiring or Generating Resources primarily result from the subsidy expense recognized for financial statement re-estimate purposes as required by the Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees*. Re-estimates published in the President's Budget generate or require resources.

Note 14. 2005 Hurricane Relief

On August 29, 2005, hurricane Katrina struck the Gulf Coast, resulting in widespread catastrophic damage to the coastal regions of Louisiana, Mississippi and Alabama. Immediately following Katrina, hurricane Rita struck the same region, adding Texas to the states already catastrophically damaged, and hindering the recovery efforts. The death toll, property damage, dislocation of families, and destruction of the infrastructure of the communities and economies of the Gulf Coast represent a humanitarian crisis that will affect these areas for many years to come.

The Department determined 33 postsecondary educational institutions had the fall 2005 academic term cancelled, delayed or interrupted as a result of Hurricanes Katrina and Rita. The significant loss of revenue attributable to the cancelled or delayed fall 2005 academic terms compounded the financial hardships institutions were experiencing due to the Gulf hurricanes.

The *National Disaster Student Aid Fairness Act*, Public Law 109-86, was enacted on October 7, 2005, and required, in part, the Secretary reallocate unexpended campus-based program funds (Federal Supplemental Educational Opportunity Grant, Federal Work-Study, and Perkins Loan) to institutions of higher education located in areas directly affected or have enrolled eligible students who were affected by hurricanes Katrina or Rita. Funds awarded are shown below.

(Dollars in Millions)	Obligated
Federal Supplemental Educational Opportunity Grant	$ 4
Federal Work Study	19
Perkins Loan	5
Reallocated Program Funds	**$ 28**

In addition to distributing the reallocated program funds, FSA is also involved in the deployment of other sources of hurricane relief aid to its education partners. Administrative costs of approximately $1 million were recorded to (1) deliver hurricane relief funds from all sources to impacted institutions in a post-hurricane environment, (2) develop policies and procedures for the changes required by enacted legislation, (3) gather information for monitoring progress, and (4) test the adequacy of internal controls.

Relief Waiver Provisions

Section 202(a) of Subtitle B-Higher Education Hurricane Relief included within the Hurricane Education Recovery Act (PL 109-148), enacted on December 30, 2005, authorized the Secretary, under certain circumstances, to waive or modify any statutory or regulatory provision applicable to the student financial assistance programs under Title IV of the HEA, as amended, as necessary in connection with the Gulf hurricane disaster. Pursuant to this authority, the Secretary determined impacted institutions in possession of Title IV funds awarded to students enrolled for the academic period disrupted will, generally, not be required to return funds for students who withdrew or who never began attendance. Aid relief related to this waiver is presented below.

(Dollars in Millions)	Total
Pell Grants	$ 10
Direct Loans, including interest	2
FFEL, including interest	16
Title IV Aid Waived	**$ 28**

Note 15. Contingencies

Guaranty Agencies

The Department can assist Guaranty Agencies experiencing financial difficulties by advancing funds or by other means. No provision has been made in the principal statements for potential liabilities related to financial difficulties of Guaranty Agencies because the likelihood of such occurrences is uncertain and cannot be estimated with sufficient reliability.

Perkins Loan Reserve Funds

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In fiscal year 2006, the Department provided funding of 84.6 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The schools provided the remaining 15.4 percent of program funding. For the latest academic year ended June 30, 2006, approximately 727,546 loans were made, totaling approximately $1.6 billion at 1,666 institutions, averaging $2,178 per loan. The Department's share of the Perkins Loan Program was approximately $6.5 billion as of June 30, 2006.

In fiscal year 2005, the Department provided funding of 84.6 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The schools provided the remaining 15.4 percent of program funding. For the academic year ended June 30, 2005, approximately 779,129 loans were made, totaling $1.6 billion at 1,653 institutions, averaging $2,069 per loan. The Department's share of the Perkins Loan Program was approximately $6.4 billion as of June 30, 2005.

Perkins Loan borrowers who meet statutory eligibility requirements—such as service as a teacher in low-income areas, as a Peace Corps or VISTA volunteer, in the military or in law enforcement, in nursing, or in family services—may receive partial loan forgiveness for each year of qualifying service. In these circumstances, a contingency is deemed to exist. The Department may be required to compensate Perkins Loan institutions for the cost of the partial loan forgiveness.

Litigation and Other Claims

The Department is involved in various lawsuits incidental to its operations. Judgments resulting from litigation against the Department are paid by the Department of Justice. In the opinion of management, the ultimate resolution of pending litigation will not have a material effect on the Department's financial position.

Other Matters

Some portion of the current year financial assistance expenses (grants) may include funded recipient expenditures that were subsequently disallowed through program review or audit processes. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Department's financial position.

During the fiscal year, the Inspector General issued an audit report that questioned payments made to an entity that participates in the Federal Family Education Loan Program. The findings cited in this report are under consideration by the Department. Until the matter is resolved, the potential impact, if any, on the Department's financial position is not possible to estimate.

REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION

Investment in Human Capital

Human capital investments are those expenses included in net cost for general public education and training programs that are intended to increase or maintain national economic productive capacity.

Federal Student Aid administers need-based financial assistance programs for students pursuing postsecondary education. Federal grants, loans and work-study funding are available to eligible undergraduate and graduate students through the following programs:

- The **FFEL Program** operates with state and private nonprofit guaranty agencies to provide loan guarantees and interest supplements through permanent budget authority on loans by private lenders to eligible students.
- The **Direct Loan Program** is a direct-lending program in which loan capital is provided to students by the federal government through borrowings from the U.S. Treasury.
- The **Pell Grant Program** awards direct grants through participating institutions to undergraduate students with financial need. Participating institutions either credit the appropriated funds to the student's school account or pay the student directly once per term.
- **Campus-Based Programs** include the SEOG, Work-Study, and Perkins Programs. Grants in these programs are made directly to participating institutions, which have considerable flexibility to package awards to best meet the needs of their students.
- Signed into law this year, the **ACG** and the **SMART Programs** are available to encourage eligible students to take more challenging courses in high school and to pursue college majors in high demand in the global economy.

Expenses incurred for human capital investments consisted of the following for FY 2006 and the preceding four years:

(Dollars in Millions)	**2006**	**2005**	**2004**	**2003**	**2002**
Direct Loan Subsidy	$6,655	$5,211	$(543)	$4,716	$877
Guaranteed Loan Subsidy	$28,062	$9,863	$8,516	$2,509	$3,988
Grant Programs	$15,447	$15,070	$14,943	$13,836	$12,256
Salaries & Administrative	$172	$164	$186	$179	$207
Total	**$50,336**	**$30,308**	**$23,102**	**$21,240**	**$17,328**

Federal Student Aid's programs link with the overall initiatives of the Department in enhancing education—a fundamental stepping stone to higher living standards for American citizens. Education is key to national economic growth. But education's contribution is more than increased productivity and incomes. Education improves health, promotes social change and opens doors to a better future for children and adults.

In the past, economic outcomes, such as wage and salary levels, have been determined by the educational attainment of individuals and the skills employers expect of those entering the labor force. Recently, both individuals and society as a whole have placed increased emphasis on educational attainment as the workplace has become increasingly technological and employers now seek employees with the highest level of skills. For prospective employees, the focus on higher-level skills means investing in learning or developing skills through education. Like all investments, developing higher-level skills involves costs and benefits.

Returns, or benefits, of investing in education come in many forms. While some returns accrue for the individual, others benefit society and the nation in general. Returns related to the individual include higher earnings, better job opportunities, and jobs that are less sensitive to general economic conditions. Returns related to the economy and society include reduced reliance on welfare subsidies, increased participation in civic activities and greater productivity.

Over time, the returns of developing skills through education have become evident. Statistics illustrate the rewards of completing high school and investing in postsecondary education.

Office of Inspector General Transmittal Letter

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

NOV 1 5 2006

Theresa S. Shaw
Chief Operating Officer
Federal Student Aid
Washington, D.C. 20202

Dear Ms. Shaw:

The enclosed reports present the results of the annual audits of Federal Student Aid's (FSA) financial statements for fiscal years 2006 and 2005, to comply with the Higher Education Act Amendments of 1998. The reports should be read in conjunction with FSA's financial statements and notes to fully understand the context of the information contained therein.

We contracted with the independent certified public accounting firm of Ernst & Young, LLP (Ernst & Young) to audit the financial statements of FSA as of September 30, 2006 and 2005, and for the years then ended. The contract required that the audit be performed in accordance with U.S. generally accepted government auditing standards; OMB's bulletin, *Audit Requirements for Federal Financial Statements*; and the GAO/PCIE *Financial Audit Manual*.

In connection with the contract, we monitored the performance of the audits, reviewed Ernst & Young's reports and related documentation, and inquired of its representatives. Our review was not intended to enable us to express, and we do not express, an opinion on FSA's financial statements, or conclusions about the effectiveness of internal control, whether FSA's financial management systems substantially complied with the Federal Financial Management Improvement Act of 1996, or on compliance with laws and regulations.

Ernst & Young is responsible for the attached auditor's report and the conclusions expressed in the related reports on internal control and compliance with laws and regulations. Our review disclosed no instances where Ernst & Young did not comply, in all material respects, with U.S. generally accepted government auditing standards.

Sincerely,

John P. Higgins, Jr.

Enclosures

400 MARYLAND AVE., S.W. WASHINGTON, D.C. 20202-1510

Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.

REPORT OF INDEPENDENT AUDITORS

ERNST & YOUNG

Ernst & Young LLP
1225 Connecticut Avenue, N.W.
Washington, DC 20036

Phone: (202) 327-6000
Fax: (202) 327-6200
www.ey.com

Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2006 and 2005, and the related consolidated statements of net cost, changes in net position, and financing and the combined statements of budgetary resources for the fiscal years then ended. These financial statements are the responsibility of FSA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 06-03*, Audit Requirements for Federal Financial Statements*. Those standards and bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of FSA's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of FSA's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FSA as of September 30, 2006 and 2005, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented in the Management Discussion and Analysis and required supplementary stewardship information is not a required part of the basic financial statements but is supplementary information required by OMB Circular No. A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Ernst & Young

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Report of Independent Auditors
Page 2

In accordance with *Government Auditing Standards*, we have also issued our reports dated November 7, 2006, on our consideration of FSA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Ernst & Young LLP

November 7, 2006

REPORT ON INTERNAL CONTROL

ERNST & YOUNG

Ernst & Young LLP
1225 Connecticut Avenue, N.W.
Washington, DC 20036

Phone: (202) 327-6000
Fax: (202) 327-6200
www.ey.com

Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2006, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 7, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered FSA's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on internal control over financial reporting. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 06-03. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

In addition, we considered the Department's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the agency's internal control, determined whether internal control had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 06-03 and not to provide assurance on internal control. Accordingly, we do not provide an opinion on such controls.

With respect to internal controls related to performance measures reported in the Management Discussion and Analysis of FSA's consolidated and combined financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 06-03. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

However, as a result of the procedures we did perform, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect FSA's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions are described below.

Ernst & Young LLP

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A material weakness, based on auditing standards generally accepted in the United States as established by the American Institute of Certified Public Accountants, is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described below is a material weakness.

FSA relies on the Department's Office of Chief Financial Officer (OCFO) to provide support for FSA's financial reporting needs. Specifically, FSA has a memorandum of understanding (MOU) with OCFO that indicates that OCFO is responsible for the following: (1) preparing FSA's financial statements; (2) performing the daily operations of processing transactions in the general ledger; (3) preparing the required financial reporting to the Office of Management and Budget and the U.S. Department of the Treasury, such as the SF-133 and the SF-224; and (4) developing and distributing accounting policies and procedures.

In addition, under the MOU, FSA is responsible for: (1) implementing accounting policies and procedures; (2) coordinating with OCFO and Budget Service on all financial reporting issues; and (3) reconciling subsidiary ledgers to supporting documentation and ledgers.

REPORTABLE CONDITIONS

1. Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Modified Repeat Condition)

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure and budget for the cost of federal loan programs. In implementing the requirements of the Credit Reform Act, and in complying with Federal accounting standards, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. Such costs are also re-estimated on a periodic basis. While improvements have been made over the last several years, particularly during fiscal year (FY) 2006, we noted that internal controls and processes surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be further refined to ensure that appropriate estimates are prepared.

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In addition, the Credit Reform Workgroup (CRW), which was created in FY 2004 and consists of managers from the Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), and Budget Service, met on a consistent basis and were heavily involved throughout the credit reform process in FY 2006. The primary purpose of the CRW was to inform the appropriate parties of key internal issues related to credit reform, and to manage the development of improved processes, procedures, and sources of information to enhance the credit reform estimation process.

However, after identifying the key improvements made or currently being made by the Department during our testing of loan guarantees, allowance for subsidy, and subsidy cost estimates, we noted the following items that indicate management controls and analysis should be strengthened:

- The long-term cost for the credit programs is reflected in the financial statements through periodic charges for subsidy costs, adjustments or re-estimates to those subsidy costs, and loan activity, which is all recognized in the allowance for the direct loan (DL) receivable and liability for the guaranteed loan (FFEL) program. The Department uses a computer-based cash flow projection model (i.e., Student Loan Model, or SLM) and OMB calculator to calculate subsidy estimates related to the loan programs that are then recorded in the allowance for subsidy or liability account. The model uses multiple sources of loan data and hundreds of assumptions. In order to perform a check of estimates resulting from the SLM and OMB calculator, the Department prepares a backcast, which compares the model's estimates to actual activity for the current and prior fiscal years. The SLM for the prior year also produces a forecast of the expected cash flows in the current year for the outstanding loans. The new data analysis tools prepared by the Department support more disaggregated reviews of data by cohort. The Department's efforts in this regard are evolving, particularly in capturing the value of the new data analysis tool. These efforts have highlighted differences between recorded activity by cohort in the Department's records as compared to expected cash flows or cash flows derived from credit systems which merit further investigation.

- The early phase of the loan estimation process includes the development of the assumptions which are used to populate the SLM with data that, in turn, feeds into the OMB calculator, which arrives at the actual cost re-estimates. In order to develop a majority of the assumptions, the Department utilizes the National Student Loan Database System (NSLDS) to extract a sample of loan data, which is known as the Statistical Abstract (STAB). The Department then executes internally developed computer programs to arrive at the assumption data that is entered into the SLM. While we understand some improvements have been made, we were informed that the programming language was not fully documented to explain the procedures executed by the programs. As a result, a review of the logic of these programs cannot be performed by someone unfamiliar with the code, which could have the potential of allowing undetected errors to exist in the development of the assumption data. We continue to advocate completion of this process.

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- The early phase of the loan estimation process includes the development of the assumptions which are used to populate the SLM with data that, in turn, feeds into the OMB calculator, which arrives at the actual cost re-estimates. In order to develop a majority of the assumptions, the Department utilizes the National Student Loan Database System (NSLDS) to extract a sample of loan data, which is known as the Statistical Abstract (STAB). The Department then executes internally developed computer programs to arrive at the assumption data that is entered into the SLM. While we understand some improvements have been made, we were informed that the programming language was not fully documented to explain the procedures executed by the programs. As a result, a review of the logic of these programs cannot be performed by someone unfamiliar with the code, which could have the potential of allowing undetected errors to exist in the development of the assumption data. We continue to advocate completion of this process.

- Particularly in areas that have relatively less predictive capability in the existing model, management should consider the use of reasonable simplified assumptions in estimate development, which can result in simpler programs, thus establishing transparency and limiting the potential for errors. The pattern of large re-estimates in the Department's programs, which reflect difficulties projecting future cash flows, can lead to a call for model enhancements which generate successively more complex and theoretically precise estimates. On balance, however, such refinements may do little to counteract the volatility of the estimates which are highly sensitive to changes in the underlying data. Introducing further complexity may create the appearance of further precision which is largely unwarranted due to the underlying volatility. Such changes, by further complicating the model and the process to develop the estimate, can also significantly increase the risk of errors in updating and running the model.

- FFEL program receivables are classified as pre-1992 loans (liquidating account loans) and post-1991 loans (financing account loans). The Department records certain collections on each of these loan categories using an estimation process (splitter process), as this information cannot be obtained directly from cash collections. The allocation of collections between liquidating and financing loans ultimately affects the liability account for loan guarantees and accounts payable to Treasury. Currently, the Department relies primarily on the output of the credit reform model to record the net value of the pre-1992 loans. The Department's financial systems are not configured to account for cash flows on a rigorous cohort level. As noted earlier, some improvements have been achieved with the development of certain aspects of cohort level analysis. Accurate cohort-level data is increasingly important to ensure that estimates in the subsidy models are appropriately adjusted as cohorts from the early 1990s wind down, and cash flows from default activities create temporary demands for cash that are currently funded on an aggregate basis across cohorts. The process may ultimately help resolve the splitter issues discussed above.

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- The Department continues to be challenged in estimating lender and borrower behavior, and relies significantly on prior patterns to estimate future activity. There may be situations, however, in which a refinement of such estimates should be made if circumstances suggest that the pattern will not repeat. Due to lags in the receipt of information on consolidation loans, the Department did not accurately estimate the split between in-school and out-of-school borrowers who consolidated in developing FY 2005 subsidy rates. When actual figures were known, it was determined that the Department had underestimated in-school consolidations, resulting in a re-estimate during FY 2006. Interest rates for in-school borrowers were much lower than for borrowers who were out of school, resulting in an increased subsidy for FY 2006.

  While patterns in the SLM reflect historical data, it seems possible that the level of consolidations will decrease significantly in the future, since many of the incentives for borrowers to consolidate, such as locking in lower interest rates in a rising interest rate environment, are no longer available. High consolidation volume has potentially artificially masked long term loan defaults and potential write-offs, since the consolidation process pays off the old loan and establishes a new loan. While the Department's approach is data based, users of the estimates should be made aware of the significant volatility of the estimates and potential for significant future re-estimates as the program changes take effect, the interest rate environment changes and actual default losses become more readily determined.

Recommendations:

We recommend that Federal Student Aid perform the following:

1. Continue to improve the analytical tools used for the loan estimation process. Ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.

2. Document, in detail, the programs written to develop the assumptions for the SLM and document scenarios under which deviation from patterns of prior cash flows are appropriate.

3. FSA should coordinate with the Department to continue to develop detailed operating procedures for the loan estimation process, which would include the step-by-step procedures that take place during the various phases of the process.

4. Efforts to more fully implement cohort reporting should continue, with specific research on whether balances in the Department's and FSA's financial records are supported by estimates, by cohort, from the SLM and the newly developed cohort analysis tool. Analytical tools should be developed to assure that the splitter process is operating as intended and that remaining credit reform estimates for each cohort are appropriate in relation to the remaining outstanding loans for such cohorts.

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2. Controls Surrounding Information Systems Need Enhancement (Modified Repeat Condition)

In connection with the annual audit of FSA's FY 2006 financial statements, we conducted a controls review of the information technology processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* identifies five components of internal control: Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring. With respect to the Control Environment and Monitoring components, the GAO publication states that:

- "management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management," and

- "internal control monitoring should assess the quality of performance over time and ensure that the findings of audit and other reviews are promptly resolved."

While the Department and FSA have made progress in strengthening controls over information technology processes and have continued making improvements in the areas of configuration management, virus protection, and security patch management during FY 2006, our audit work and audit reports prepared by the Office of Inspector General (OIG) identify certain control weaknesses, including several that were repeat conditions, within information technology security and systems that need to be addressed.

More specifically the Department and FSA should: (1) strengthen access controls to protect mission critical systems (e.g. user provisioning process, periodic access revalidation, timely removal of user access, physical data center access controls); (2) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with best practices; (3) enforce the use of complex passwords in all systems across the organization; (4) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the

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security weaknesses across the organization; (5) implement consistent tape back up controls; (6) strengthen security incident handling procedures and intrusion detection systems; (7) consistently perform risk assessments and Certification and Accreditation on its new systems and new environments, especially after migrating to a new location or a new system; (8) improve private data protection controls (e.g. proper disclosure of the use of 'cookies' on Department and FSA websites and polices and procedures on dial up access and encryption of back up data); (9) enhance its security training and awareness program and the monitoring of this program, specifically in accounting for completion of such training by all employees and contractors; (10) improve protection of sensitive information, including read-only access to personally identifiable information on Department and FSA systems; and (11) the Office of Management should continue its efforts to reconstruct its inventory database or otherwise reconcile its physical inventory of computing and other equipment to ensure that all Department and FSA computing resources and the data residing in them are secured and safeguarded.

The OIG has identified significant deficiencies for the Department in its 2006 Federal Information Security Management Act (FISMA) report in the areas of (1) the Department's management control structure in incident handling and intrusion detection systems which restrict its ability to reasonably identify and report suspicious activity occurring on the Department's and FSA's systems; and (2) the Department's and FSA's configuration management program that restricts its ability to reasonably maintain security over its systems in a consistent manner. In addition, a number of repeat conditions were noted in our work and in the OIG's audit reports, an indication that the control environment and monitoring components of internal controls at the Department and FSA require additional focus.

Recommendation:

1. Audit resolution activities have traditionally been focused around addressing the immediate security and control weaknesses identified by audit reports rather than a detailed evaluation of the root cause for the identified weaknesses, which is indicated by the number of repeat findings. We recommend that the Department and FSA continue efforts to address security and control weaknesses disclosed in audit reports or identified in internal self-assessments with an emphasis on addressing the root cause of the security or control weakness, which should decrease the likelihood of a similar weaknesses being identified in future audit assessments and internal self-assessments. Examples of addressing root causes may include, but are not limited to, additional training for the information technology professionals within the organization, updates to procedures to ensure proper configuration of servers against documented hardening standards at the time of deployment, and auditing performance-based contracts of vendors providing system support services to the Department and FSA.

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STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the fiscal year 2005 audit of the Federal Student Aid financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

Summary of FY 2005 Reportable Conditions

Issue Area	Summary Control Issue	FY 2006 Status
Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Reportable Condition)	Management controls and analysis need to be strengthened over credit reform estimation and financial reporting processes.	Improvements noted – Modified Repeat Condition Reportable Condition
Controls Surrounding Information Systems Need Enhancement (Reportable Condition)	Improvements are needed in overall information technology security management.	Improvements noted – Modified Repeat Condition Reportable Condition

We have reviewed our findings and recommendations with FSA management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

In addition to the reportable conditions described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated November 7, 2006.

This report is intended solely for the information and use of the management of FSA and the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

November 7, 2006

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

Ernst & Young LLP
1225 Connecticut Avenue, N.W.
Washington, DC 20036

Phone: (202) 327-6000
Fax: (202) 327-6200
www.ey.com

Report on Compliance with Laws and Regulations

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2006, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 7, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*.

The management of FSA is responsible for complying with laws and regulations applicable to the entity. As part of obtaining reasonable assurance about whether the entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 06-03, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to FSA.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03. We noted certain other matters involving compliance with laws and regulations that were reported to management in a separate letter dated November 7, 2006.

Under FFMIA, we are required to report whether FSA's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. FSA relies on the Department's systems to provide support for FSA's financial reporting needs, including utilizing the Department's general ledger to process transactions. We have identified the following instance of noncompliance:

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While the Department and FSA have made progress in strengthening controls over information technology processes and have continued making improvements in the areas of configuration management, virus protection, and security patch management during FY 2006, our audit work and audit reports prepared by the Office of Inspector General (OIG) identify certain control weaknesses, including several that were repeat conditions, within information technology security and systems that need to be addressed. More specifically, the Department and FSA should: (1) strengthen access controls to protect mission critical systems (e.g. user provisioning process, periodic access revalidation, timely removal of user access, physical data center access controls); (2) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with best practices; (3) enforce the use of complex passwords in all systems across the organization; (4) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the security weaknesses across the organization; (5) implement consistent tape back up controls; (6) strengthen security incident handling procedures and intrusion detection systems; (7) consistently perform risk assessments and Certification and Accreditation on its new systems and new environments, especially after migrating to a new location or a new system; (8) improve private data protection controls (e.g. proper disclosure of the use of 'cookies' on Department and FSA websites and polices and procedures on dial up access and encryption of back up data); (9) enhance its security training and awareness program and the monitoring of this program, specifically in accounting for completion of such training by all employees and contractors; (10) improve protection of sensitive information, including read-only access to personally identifiable information on Department and FSA systems; and (11) the Office of Management should continue its efforts to reconstruct its inventory database or otherwise reconcile its physical inventory of computing and other equipment to ensure that all Department and FSA computing resources and the data residing in them are secured and safeguarded.

The Report on Internal Control includes additional information related to the financial management systems that were found not to comply with the requirements of FFMIA relating to information technology security and controls. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMIA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department and FSA. Management concurs with our recommendations and, to the extent findings and recommendations were noted in prior years, has provided a proposed action plan to the OIG in accordance with applicable Department directives.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

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This report is intended solely for the information and use of the management of FSA and the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

November 7, 2006

MANAGEMENT'S RESPONSE

START HERE
GO FURTHER
FEDERAL STUDENT AID

November 8, 2006

MEMORANDUM

TO: John P. Higgins, Jr.
Inspector General

FROM: Victoria L. Bateman
Chief Financial Officer
Federal Student Aid

SUBJECT: AUDIT REPORTS
Financial Statement Audit for Fiscal Years 2006 and 2005
Federal Student Aid
U.S. Department of Education
ED-OIG/A17G0004

Federal Student Aid wishes to express our appreciation for the efforts and professionalism of the Office of Inspector General and our auditors, Ernst & Young, LLP, in their audit of our fiscal year 2006 financial statements. We concur with the findings and recommendations as identified in the reports.

Federal Student Aid continues to support the Department of Education's efforts to address the reportable condition related to the credit reform estimation and financial reporting processes. We recognize that significant additional work remains to be accomplished in order for the Department to have a fully institutionalized practice.

We are committed to maintaining an unqualified opinion in future fiscal years and we will continue to prioritize corrective actions to eliminate reportable conditions and other matters as noted in this report. In addition, working with the Department, we will continue to implement additional improvements on controls over information systems.

Once again, we thank the Office of Inspector General and Ernst &Young for their efforts to complete a successful audit of Federal Student Aid's financial statements and internal controls.

START HERE
GO FURTHER
FEDERAL STUDENT AID